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An Examination of the Influence of Inheritance Tax upon Business Succession - Lessons for Germany

Michael Haug, Luise Hölscher and Tim Vollans*

Abstract

Family enterprises form the backbone running right through the economy of nations; therefore the business environment and business succession are subjects which are currently receiving widespread attention in most European countries. In Germany there are about 350,000 enterprises - most of them are family-owned - which will have to carry out business succession during the next five years. One major factor influencing business succession is taxation. Many business successions are completed within the family without financial compensation, so there is a strong connection between business succession and inheritance tax as a major fiscal threat. In Germany over the past years there has been intensive discussion about the liquidity burden created by inheritance tax liability endangering the continuation of family enterprises. The inheritance tax rules for business property under discussion in Germany are somewhat similar to the UK ones. Moreover, the UK legal system is more favourable to business succession than most European countries. Therefore the prospective reform in Germany will be informed through an exchange of scholarly experience and also improved by using established recommendations based on the existing UK inheritance tax system. With respect to the German parliament's consideration of an inheritance tax reform bill, the research analyses the impact of inheritance tax on business succession decisions. Thus this research sought both to improve the basis for decision-making by the legislators and also to avoid undesired tax incentives in terms of business succession. The research methodology involved an empirical examination of the impact of the inheritance tax on business succession including personal interviews and written questionnaires with UK tax professionals.

1. INHERITANCE TAX AND THE PLANNING OF BUSINESS SUCCESSION

1.1 Background of research question

In the second half of the 20th century economic growth and political stability allowed the accumulation of private and business wealth in Germany. Those assets are now and in the next years to be given to the following generation.¹ Accordingly, business succession will be an important task to be handled. Following recent statistics, about 350,000 companies with approximately 3,400,000 employees in Germany have to be transferred in the next five years.² From this point of view, business succession can be seen as a major task for the German economy.³

Many factors have an influence on business succession. Management, legal and psychological questions have to be considered, but taxation also plays an important

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¹ See Kohli, M./Künemund, H./Schäfer, A. et al. (2006), p. 58.

² See Institut für Mittelstandsforschung (ed.) (2005).

³ See Spiegelberger, S. (2007), p. 354.

role.⁴ The inherent complexity leads to specific challenges for the senior generation as for the successor.⁵ The general aim of a business succession – not only from the successor's personal point of view, but also from a German constitutional perspective,⁶ is to guarantee the survival of the company and its jobs as well as the economic existence of the successor in the long run.⁷ For closely held companies, especially if held by a family, the going concern of the company under family supervision can be an aim itself.⁸

Almost 95% of all companies existing in Germany are managed by families. Each year nearly 71,000 companies are to be transferred,⁹ and in the past approximately 44% were succeeded by a relative.¹⁰ Intra-family business succession is generally not on a (100%) for-money-basis, so gift and inheritance taxes have a major influence on structure and timing of business succession. Accordingly, tax optimisation is seen as an important task in the process of planning such kind of succession.¹¹

Inheritance tax has to be paid out of the successor's property and thus can lead to an extraordinary reduction of liquidity.¹² As business succession is not normally planned under liquidity aspects, the successor has to liquidate his private property and may even be forced to extract liquidity from the business.¹³ This can lead to a lack of liquidity at the company level and may even threaten its going concern.¹⁴ To resolve such problems, the German tax system provides a tax deferral in such cases,¹⁵ but as it is subject to strong restrictions, it is of low importance for the praxis of succession planning.¹⁶ Additionally, these regulations only shift the tax burden in time without abolishing it, so they lead to a mere time effect.¹⁷

The European Communities see causality between the failure of business succession and the connected tax burden¹⁸ and are regularly confirmed in their opinion by scientific literature.¹⁹ Even as there has not been any empirical proof for this assumption, it can be seen as a major reason for the ongoing discussion of inheritance tax reforms in Germany.²⁰

⁴ See Friedrich, K./Steidle, B./Gunzelmann, U. (2006), p. 19.

⁵ This can be seen easily by counting the amount of information brochures and practical guidelines of chambers of commerce and professional associations. See e.g. Industrie- und Handelskammer Baden-Württemberg (ed.) (2005); Deutscher Industrie- und Handelskammertag (ed.) (2004); Bundessteuerberaterkammer (ed.) (2007).

⁶ See Art. 14 Abs. 2 GG.

⁷ See Steuerberaterkammer Stuttgart (ed.) (2006), p. 6.

⁸ See Watrin, C. (1997), p. 18.

⁹ See Bundesministerium für Wirtschaft und Technologie (ed.) (2007), p. 12.

¹⁰ See Gesmann-Nuissl, D. (2006), p. 2; Bundesministerium für Wirtschaft und Technologie (ed.) (2007), p. 38.

¹¹ See Watrin, C. (1997), p. 18 ff.

¹² See Lehmann, D./Treptow, O. (2006a), p. 413.

¹³ See Karle, M. (2006), p. 12.

¹⁴ E.g. see Schaumburg, H. (2006), p. 22.

¹⁵ See § 28 ErbStG.

¹⁶ See Schulte, W. (2007), p. 320.

¹⁷ See Scheffler, W./Wigger, B. U. (2006), p. 2445.

¹⁸ See Kommission der Europäischen Gemeinschaften/Commission of the EU (1994), p. 2.

¹⁹ E.g. see Schaumburg, H. (2006), p. 22; Scheffler, W./Wigger, B. U. (2006), p. 2445.

²⁰ See Ziegler, J. (1996), p. 454.

On 11th December 2007, the German government once again published a new version of an inheritance tax reform that still gives space for discussion in several details.²¹ An important influence on this draft was the judgement of the highest German court of justice, dated on 7th November 2006:²² which forces the German government to abolish gift and inheritance tax if no re-regulation is implemented up to the end of 2008. Since the beginning of 2009, a revised Inheritance Tax Act is available, but the discussion about possible effects on business succession continues.

1.2 Problem, aim and structure of discussion

Tax policy is one of the most discussed topics in German legislation.²³ Due to the dynamic surrounding, tax legislation always has to be adjusted according to changing circumstances.²⁴ This process can be done on a theoretical basis, but instead of retrospective evaluation and changes it seems to be of more practical use to get a prospective insight into the causalities to avoid “trial and error” legislation as much as possible. Tax policy should be guided by well defined political goals and thus needs detailed information about economic results of specified tax changes. Without such knowledge of tax effects, no clear ex ante-evaluation of tax reform prototypes can be done. Besides that, the government has to face the danger of unforeseen and unpleasant side effects of their reform. This seems evident in case of tax reforms that are structured under the aim of self-financing or increase of tax revenue.²⁵ Under these circumstances it seems questionable whether a goal-oriented tax policy can be achieved without fundamental scientific knowledge about the effects of tax reforms.

There is no clear evidence about how far taxation has an influence on taxpayers’ economic decisions. Even with an inheritance tax broadly discussed in the recent past, little research has been conducted.²⁶ Science faces a particular lack of empirical data about practical influence of inheritance tax on business decision.²⁷ But, a reliable data basis is seen as basic condition for an effective and goal-driven tax policy.²⁸

The effect on decisions by gift and inheritance taxes have been determined in the past mainly based on theoretical decision models that start with the assumption of a taxpayer with the one and only goal of minimising his tax burden.²⁹ This will be the case for business successions, too, but neglects psychological aspects influencing the economic decision. As has been shown, business successions in particular have a strong psychological impact and thus can be analysed only partly by models that are merely tax driven. If the aim is to determine behavioural effects of taxation, empirical research is needed.³⁰ As there is a lack of empirical data about business succession decisions based on monetary plus psychological reasons, such kind of data basis has to

²¹ Kabinettsache 16/08146 of 06.12.2007.

²² BVerfG, 1 BvL 10/02, et al. DSStR 2007, p. 235 ff.

²³ See Schratzenstaller, M. (2007), p. 21.

²⁴ See Becker, J./Fuest, C. (2007), p. 47.

²⁵ Driven by restrictions of public households, the gift and inheritance tax reform must not have an influence on the tax return of approximately €4 billion.

²⁶ See Schupp, J./Szydlik, M. (2004), p. 3; Lehmann, D./Treptow, O. (2006b), p. 323.

²⁷ See Lehmann, D./Treptow, O. (2006a), p. 413.

²⁸ See Herz, W. (2006), p. 22.

²⁹ See e.g. Scheffler, W./Spengel, C. (2004b); Spengel, C./Broer, E. (2008), p. 86 ff.

³⁰ See Rose, G. (1982), p. 224.

be determined first.³¹ In a second step it will be possible to design goal-oriented and long-lasting gift and inheritance tax reform.

There is little knowledge about evaluation of primary empirical data in the field of tax research, especially in Germany. Thus, the research project underlying this paper had two different aims to fulfil:

- The first **aim with regards to the content** of the research is empirical research on decision effects of inheritance tax that will provide causality information between tax principles on one side and intra-family business succession on the other. Based on this, an evaluation of tax reform alternatives is possible. In a further step, political advice for tax legislation are deduced in an “if then”-format for tax legislation.
- The second **aim with regard to method** is an improvement of empirical tax research in Germany, which has been underrepresented in the past. Using different instruments developed by empirical social researchers will give broad information about pros and cons of these methods in tax research.

In this paper, chapter 2 describes the theoretical framework for the research project. The role of the British tax system as a blueprint for the German inheritance tax reform (chapter 3) and the design of the study (chapter 4) are then explained. Chapter 5 contains the results of a first survey and is split up into evidence of the general influence of inheritance tax on business succession decisions on one hand and in analysis of special regulations in the British Inheritance Act on the other. A summary and an appraisal (chapter 6) lead to the additional questions that are worthy of further research (chapter 7).

2. METHODOLOGY

2.1 Foreign tax systems as blueprint for national tax reforms

The basic idea of German inheritance tax reform is a model of incentivising the transfer of business assets that was in its main structures copied from the British tax system:³² Well-defined circumstances lead to business assets being freed from gift and inheritance tax burden partly or all in all. As stated by the highest German court of justice, the Federal Constitutional Court (Bundesverfassungsgericht), in 1995,³³ the German inheritance tax system has to provide special regulations for the transfer of business assets in a manner that ensures that the going-concern of the transferred firm is not endangered by the tax burden.³⁴ As the British tax system has provided such regulations for several decades now, it seems self-evident to introduce parts of them in Germany as well.

³¹ Statistics about gift and inheritance tax were abolished in Germany in the early 1980s. For the fiscal year 2002, the Federal Statistical Office (Statistisches Bundesamt) has made a new survey. Beginning with the fiscal year 2007, gift and inheritance statistics shall be done regularly. See § 2 Abs. 7 Nr. 2 StStatG.

³² See Birk, D./Pöllath, R. (2006), p. 209; Maiterth, R./Niemann, R./Blaufus, K. et al. (2006), p. 2702; Wachter, T. (2007), p. 582; Richter, A. (2008), p. 62.

³³ See BStBl II 1995, p. 671 ff.

³⁴ See Albrecht, P. (1997), p. 482.

Using the British inheritance tax system as a blueprint has been suggested several times in the past by the European Commission³⁵ as well as in literature³⁶ and was topic of general discussions.³⁷ The Commission even directly recommended the British model for tax system reorganisations in the EU member states,³⁸ and as recently as European Autumn 2007 the International Fiscal Association (IFA) discussed the advantages for Germany in learning from Great Britain in the field of taxation of business successions.³⁹ For this reason, the research project described on the following pages was based on British inheritance tax law.

2.2 Theoretical framework

The research project is based on a hypothetic-deductive understanding of science,⁴⁰ leading to a general research structure of (1) definition of hypotheses, (2) evaluation of variables and (3) test of the hypotheses based on empirical primary data. In this context, the term “hypothesis” is understood as an assumption of causalities with the aim to identify interrelations (instead of the measurement of stand-alone variables).

In social sciences, an empirical theory is seen as a system of hypotheses that (a) are using well-defined terms and (b) are free of discrepancies.⁴¹ The discussion of possible inheritance tax reforms has lead to several assumptions of interrelations, none of them yet being tested by scientific research yet.⁴² For this reason, they are used for deduction of general research hypotheses as well as for theoretical discussion of probable decision effects of inheritance tax systems. Personal experience in tax advisory for business successions is added.⁴³

2.3 Methodological framework

Following the above-mentioned understanding of sciences, emphasis has to be set on the scientific test of hypotheses.⁴⁴ The analysis methods and instruments are taken from the area of empirical behavioural research in socio-economics:

Empirical reality exists in natural situations or can be designed artificially. Accordingly, empirical research offers different methods for controlled and systematic data evaluation. Basis techniques for primary data evaluation are interrogation, observation, analysis of contents as well as so-called non-reactive evaluation methods,⁴⁵ the latter two not being appropriate for this research context. Observation in the sense of participation of the scientist obviously has to be excluded in the area of inheritance tax. What remains is the interrogation as first-best method. The research design has to follow this conclusion.

³⁵ See Kommission der Europäischen Gemeinschaften/Commission of the EU (1994a), p. 1.

³⁶ See Ritter, W. (1994), p. 2290; Ziegler, J. (1996), p. 456.

³⁷ See Kühn, A. (1996), p. 11; Albrecht, P. (1997), p. 482.

³⁸ See Kommission der Europäischen Gemeinschaften/Commission of the EU (1994b), p. 12.

³⁹ See Richter, A. (2008), p. 59 ff.

⁴⁰ See Kromrey, H. (2006), p. 85 f.

⁴¹ See Kromrey, H. (2006), p. 52.

⁴² E.g. see Bundesverband der Selbständigen/Deutscher Gewerbeverband (ed.) (2004), p. 3; Arbeitsgemeinschaft Selbständiger Unternehmer (ed.) (2002), p. 1.

⁴³ Hypotheses are stated in table 2 of chapter 5.

⁴⁴ See Kromrey, H. (2006), p. 91.

⁴⁵ See Atteslander, P. (2006), p. 49; Diekmann, A. (2006), p. 371 ff.; Kromrey, H. (2006), p. 317 ff.

In empiric socio-economic research, interrogation is seen as the most used and most developed method for data evaluation.⁴⁶ Behavioural research in the field of decision effects of taxation can be done solely in this manner, as motives for the taxpayers' decisions have to be evaluated verbally.⁴⁷ Despite methodological and practical limitations, interrogations are seen as the single proper method for field research with the aim of determining tax mentalities.⁴⁸

Empirical research is in most cases based on only one or few evaluation instruments and thus can lead to instrument-specific distortions.⁴⁹ By the parallel use of several methods, such problems can be avoided or at least be under better control. Additionally, research based on more than one method uses more than one strategy of operationalisation and thus leads to more reliable results. For this reason, empirical research might use written questionnaires as well as oral interviews for data evaluation.

Standardised written or oral interrogations allow a generalised measurement, mostly with the questioned person being the party whose reactions are to be measured. But, in an expert-interrogation, the questioned person has only informational status, informing the interrogator about the person concerned, its characteristics and economic decisions.⁵⁰ So expert-interrogation is an indirect method of evaluation and is as far accepted for empiric, socio-economic research.⁵¹ For this research project, it seems to be appropriate because of the following reasons:

(1) High complexity of research topic. Practical experience shows that business decision-makers usually rely on experts for analysis of tax aspects, caused by the high complexity of this legal area.⁵² Due to this, experts have a deeper insight into tax effects in detail.

(2) Objectivity of tax advisors. As entrepreneurs are personally affected by tax systems, their judgements will often be influenced by individual settings. To exclude subjectivism, experts can be used as a more neutral source of information.⁵³

(3) Status of a multiple. Tax experts usually concentrate on specific areas of advisory and thus have accumulated practical knowledge. As an entrepreneur can give information only about his own decisions, well-experienced experts can answer the research questionnaire based on multi-annual experience in a broad range of situations. Thus, they can be used as multiples in the process of data evaluation.⁵⁴

In the following chapters, experts will be defined as tax advisors that complete advisory work for business successions under the British inheritance tax system.

⁴⁶ See Diekmann, A. (2006), p. 371; Kromrey, H. (2006), p. 358.

⁴⁷ See Hüsing, S. (2007), p. 3.

⁴⁸ See Hosing, S. (2007), p. 24 f.; as an example for empiric research about "felt" tax burden using written questionnaires see Dietrich, M./Kiesewetter, D./Moosmann (2006).

⁴⁹ See Kromrey, H. (2006), p. 535.

⁵⁰ See Kromrey, H. (2006), p. 257 ff., p. 391 f.

⁵¹ E.g. see Felden, B. (2007), p. 475 ff.

⁵² An empirical survey shows for example that about 78% of the polled Swiss entrepreneurs included their tax advisors and chartered accountants in the process of succession; see PricewaterhouseCoopers (ed.) (2005), p. 28 f.

⁵³ See Kromrey, H. (2006), p. 107.

⁵⁴ An example can be seen at Felden, B. (2007), p. 475 ff.

The results of a first survey described in chapter 5 are based on information of 20 participants. The tax professionals that have been interviewed are divided into three categories of experience (CE). The categorisation has been done particularly with regard to the number of business successions that have been advised (see table 1). The criterion "cases per professional" corresponded largely with the temporal and professional work experience of the participants that has also been requested in the survey.

As illustrated in table 1 the evaluation that is given by all of the participants is based on at least 666 business successions.

TABLE 1: DATABASE OF THE SURVEY

CE	Cases per professional	Number of professionals	Database
1	< 10	3	3
2	10 - 30	4	40
3	> 30	13*	403 (623*)
* this includes 11 professionals with > 50 cases			446 (666*)

3. SURVEY OF THE BRITISH INHERITANCE TAX SYSTEM

For a survey on the British Inheritance Tax Act (IHTA) concerning transfers of business as assets, the focus has been set on the special regulations of Potentially Exempt Transfers (PET) and Business Property Relief (BPR). Seen from an economic perspective, these regulations seem comparable to major parts of the German inheritance tax reform suggestions. The other parts of the IHTA are not described in this text, but can be read in the law itself⁵⁵ or in the literature mentioned later.

British inheritance tax is levied based on the Inheritance Tax Act (1984) and its annual amendments, the so-called Finance Acts.⁵⁶ It is a type of duty on death or gift⁵⁷ and so far different from the German system of tax on succession. In the UK, tax is levied on the value of heritage, not on the increase in wealth at the level of the beneficiary as in Germany. IHT is levied in both cases of inheritance by death and of gift beyond living parties. Gifts beyond living parties are tax exempt if the donor lives for at least seven years after the donation, (making the transfers so-called Potentially Exempt Transfers (PET)). If the donor dies during this seven year period, inheritance tax is levied on a pro-rata-temporis basis.⁵⁸ IHT is therefore an inheritance as well as a gift tax, with the gift tax being potentially avoidable through time, partly or in the whole amount.

Next to the PET regulation the IHTA offers a broad variety of tax reductions and tax reliefs for the transfer of certain business assets by death or beyond living, called Business Property Relief (BPR).⁵⁹ These incentives can be seen as a material element of the British inheritance tax system,⁶⁰ as the transfer of a well defined group of business assets (the so-called Relevant Business Property) is taxed after a value

⁵⁵ See <http://www.hmrc.gov.uk/ihta/index.htm>.

⁵⁶ See Alberts, W. in Mennel, A./Förster, J., *Steuern Großbritannien*, Rn. 256.

⁵⁷ See Kau, M. in Wilms, H./Jochum, G., *Erbschaftsteuergesetz*, Anhang 2 Rn. 151.

⁵⁸ See IHTA 1984 s 3 A, 7 (4).

⁵⁹ See IHTA 1984 s 104.

⁶⁰ See Richter, A. (2008), p. 59.

reduction of 50% or even 100%. Thus, inheritance tax can be avoided partially or totally.

In order to make use of such incentives, the following conditions must be fulfilled:

- a) The fundamental condition for accessing the incentives is the existence of an active trading operation (IHTA 1984 s 105(3)). The aim of the regulation is the exclusion of investment companies from gaining access to the incentives, so the condition can be seen as an activity or productivity clause. In the case of mixed use for trade and production (being active) as well as for investments (being passive) the incentives are restricted to assets used wholly or mainly for active operations. In order to determine which part of a company can be transferred with a reduced or nil tax burden, the balance sheets have to be analysed to separate active from passive property.
- b) Incentives are possible only for business assets that are not used for activities defined as excluded business.⁶¹ Exclusion is mainly for activities such as trading shares, trading real estate or holding participations. An exception exists for holding companies with subsidiaries not conducting excluded business.⁶²
- c) Business assets subject to a binding sales contract cannot access the incentives, even if they fulfil all other conditions.⁶³
- d) In addition to assets that are used in excluded business activities, single assets (known as excepted assets) can also be excluded from tax incentives. Excepted assets are characterised by not being used mainly for business purposes in the past two years and not being planned for business use in the following two years.⁶⁴ Excluded assets can not be included in the amount designed for BPR incentives.⁶⁵
- e) In order to gain access to the incentives, business assets must have been kept in the transferor's property for at least two years prior to the transfer.⁶⁶

The incentives can be used only for the above-mentioned relevant business property and result in either a 100% or a 50% reduction of the taxable amount.⁶⁷ The 100% reduction, i.e. the full tax exemption, is possible for the transfer of the following assets:

- a) Business and interest in a business including sole proprietorships and partnerships.⁶⁸
- b) Above 50% of securities in a non-quoted corporation as well as non-quoted shares in corporations without a minimum participation requirement.⁶⁹

The 50% reduction, i.e. 50% tax exemption, is allowed on the transfer of:

⁶¹ See IHTA 1984 s 105 (3).

⁶² See IHTA 1984 s 105 (4)(b).

⁶³ See IHTA 1984 s 113.

⁶⁴ See IHTA 1984 s 112 (2).

⁶⁵ See IHTA 1984 s 112 (1).

⁶⁶ See IHTA 1984 s 106.

⁶⁷ See IHTA 1984 s 104 (1)(a) and (b).

⁶⁸ See IHTA 1984 s 105 (1)(a).

⁶⁹ See IHTA 1984 s 105 (1)(b), (bb).

- a) More than 50% of the securities of a quoted corporation,⁷⁰ and
- b) Real estate as well as plant and machinery if used mainly or exclusively by a qualified shareholder or by the partner of a partnership.⁷¹

Basically, the British tax incentives on PETs and the Business Property Relief for relevant business property are the regulations discussed broadly for the reform of inheritance tax in Germany. This can be seen as the starting point for the research project discussed on the following pages.

4. RESEARCH STRUCTURE

The results presented in the next chapter are taken from a larger research project. The following figure gives an overview on the structure of this project and its basic steps.⁷² After having defined the research question and analysed the research objective, hypotheses were derived from literature and personal practice in tax advisory as to how and to what extent taxation of gifts and inheritances can influence the decisions that are to be made regarding business successions.

Next, the research methodology was chosen, data evaluation instruments were designed, and after selection of probands, a pre-test was carried out. The main part of this manuscript is used to describe the evaluation of first available data and to deduce first evidence about the validity of the formerly derived hypotheses or interrelations. All other steps of research are described in so far as is needed for further understanding.

The first questionnaire and interview guideline was constructed based on state of the art-literature about socio-empiric research.⁷³ Questions of conception and quality assurance were discussed with the centre for interrogation, methods and analysis (Zentrum für Umfragen, Methoden und Analysen – ZUMA) in Mannheim, Germany, and further experts of the pedagogic institute at the University of Mainz. After the first version of the questionnaire was written in German, it was translated into English using the HM Revenue & Customs Inheritance Tax Glossary of Terms.⁷⁴ A second quality test was done by an English native speaker. The last test was made by two British tax experts, filling in the questionnaire independently. As no amendments or questions were sent back, the questionnaire's quality was determined to be sufficient. Based on this positive return, an interview guideline was extracted from the written questionnaire. The results available in this paper are based on data that have been collected by use of the guideline for personal interviews with British tax experts in November, 2007. These experts were chosen from nation-wide operating law or business advisory companies, performing tax advisory at a partner level in the private clients-area.⁷⁵

⁷⁰ See IHTA 1984 s 105 (1)(cc).

⁷¹ See IHTA 1984 s 105 (1)(d).

⁷² The figure was constructed referring to Kromrey, H. (2006), p. 76 ff.

⁷³ See especially Atteslander, P. (2006); Bortz, J./Döring, N. (2003); Diekmann, A. (2006); Jacob, R./Eirmbter, W. H. (2000); Kromrey, H. (2006); Mayer, H. O. (2006).

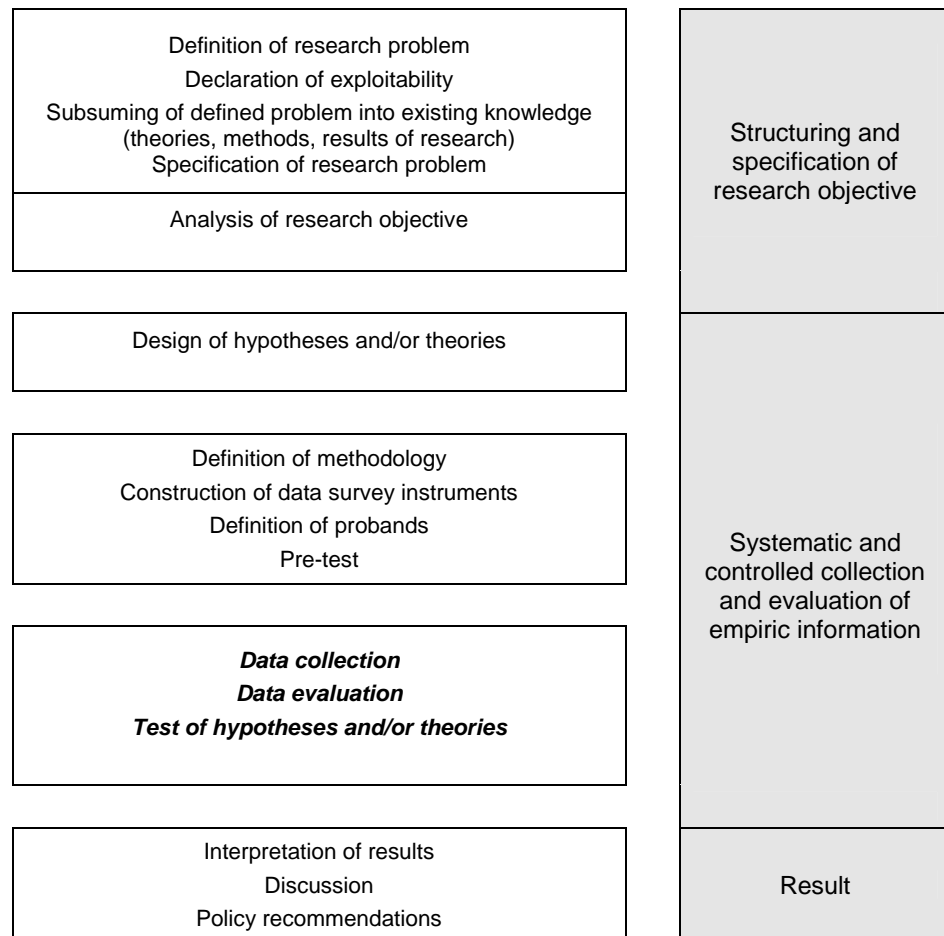
⁷⁴ See HM Revenue & Customs (2007).

⁷⁵ In UK, tax planning for business succession is done mainly in cooperation of tax advisors, tax accountants, business consultants and solicitors.

Additionally, the written questionnaire was sent out with support of the Society’s of Trust and Estate Practitioners (STEP) Worldwide Office in London. The second survey covers about 200 members of the Family Business Special Interest Group at STEP and as far as possible gives a guarantee as to the practitioners’ expertise in gift and inheritance tax advisory. The questionnaire was sent in Summer 2008 via email by STEP’s Chief Executive, and return is still ongoing. Several reminders have been sent.

The willingness of tax professionals to participate in the survey was very low. A possible reason for this may be because tax advisors and solicitors currently have large workloads due to the announcement by the legislator of further essential changes of the British tax law. This would, in many cases, require a form of financial compensation to be given to advisers as an incentive for them to participate in a survey. Therefore the database actually consists of the personal interviews. This database will need to be enlarged by doing further research (see chapter 7), if the results of this first survey are helpful for the research question.

FIGURE 1: RESEARCH PROCESS



5. RESULTS OF THE SURVEY

5.1 Preliminary remarks

In the following we describe the results of the survey among British tax professionals concerning the general effects of the inheritance tax on business succession as well as effects of specific regulations of the British Inheritance Tax Act.

The figures show the results over all of the three categories of experience and additionally the evaluation of the participants with the most experience (CE 3). One participant represents 5% (over all CE) respectively 7,7% (CE 3). The percentage values in brackets that are mentioned under the figures show the evaluation that has been given by participants with most of experience (CE 3).

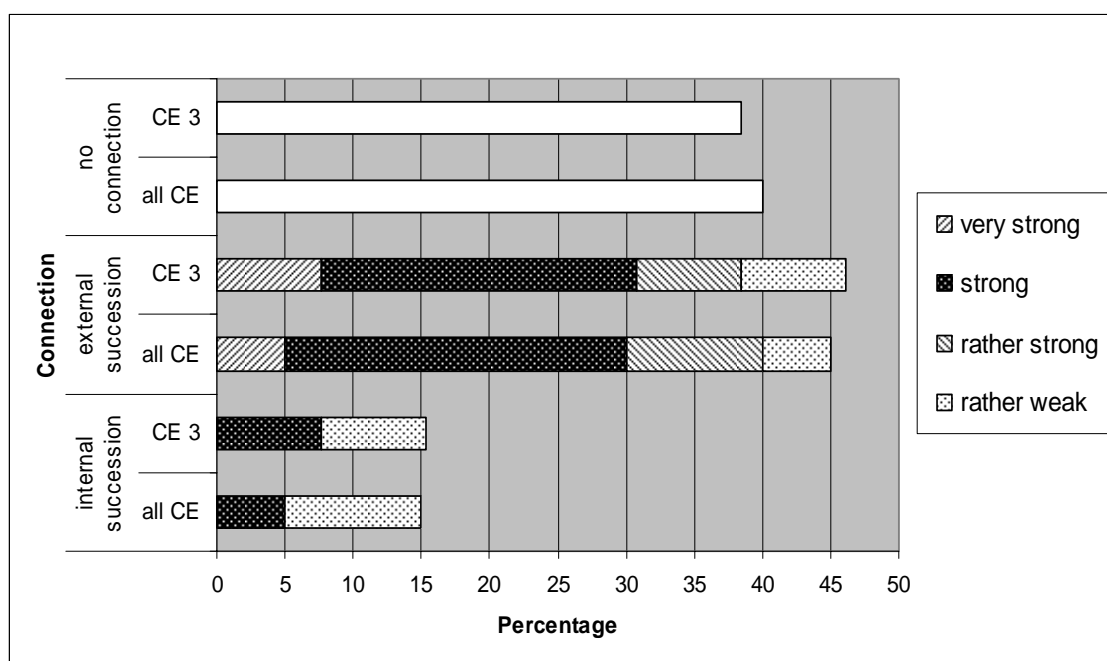
The categories of answers consist of "very strong", "strong", "rather strong", "rather weak", "weak" and "very weak". If one of these categories does not exist in the evaluations, it is not shown in the respective figure.

5.2 General effects of the inheritance tax on business succession

5.2.1 Liquidity burden and way of succession

Figure 2 shows if there is a connection between the liquidity burden due to taxation and whether the business succession occurs within the family (internal succession) or by external succession, typically by selling the enterprise. If there is a connection from experience, the figure illustrates also the strength of this connection.

FIGURE 2: LIQUIDITY BURDEN AND WAY OF SUCCESSION



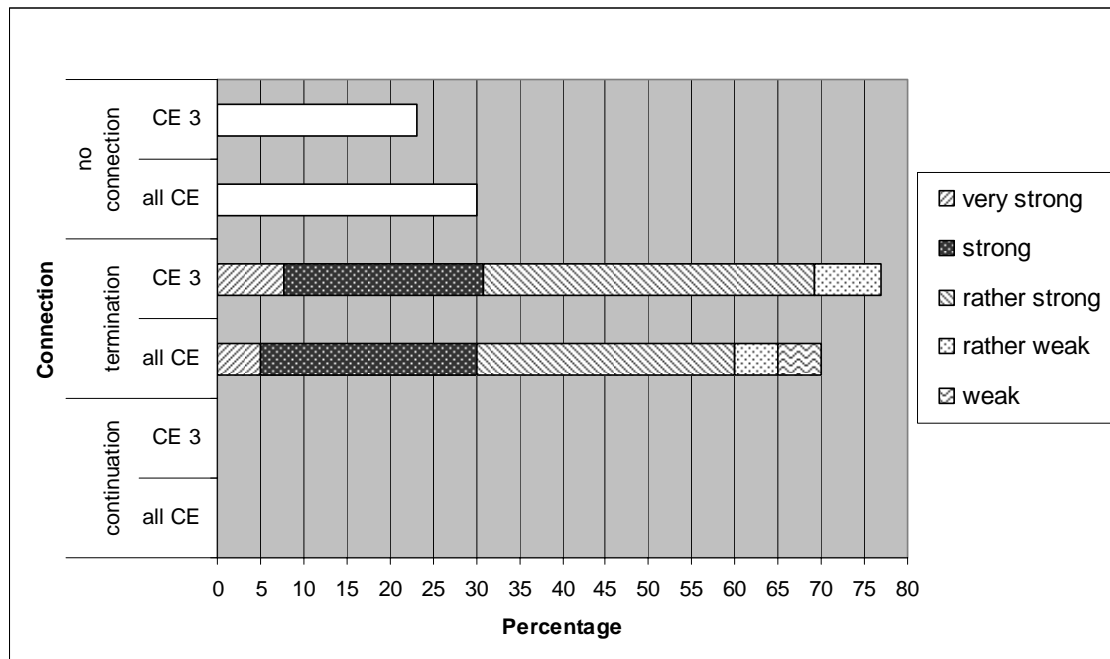
A connection between the liquidity burden due to inheritance tax and the way of succession is confirmed by 60% (61,6%) of the interviewed tax professionals. 45% (46,2%) of them evaluate the connection as "very strong", "strong" and "rather strong", and can be summarised as an overall strong connection.

15% (15,4%) of the professionals are of the opinion that business successions occur within the family despite the higher liquidity burden. The reason for this is the expectation of the successors that the liquidity burden can be compensated after the enterprise has been successfully continued within the family for some years. However 45% (46,2%) believe that the higher the liquidity burden, the more probable an external succession becomes. 40% (38,4%) state that there is no connection between the liquidity burden due to inheritance tax and the way of succession.

5.2.2 Liquidity burden and continuation of the enterprise

Figure 3 shows if the participants believe there is a connection between the liquidity burden due to taxation and greater probability of either the continuation of an enterprise by the successor or the termination of the enterprise at a later date. The strength of this possible connection is also shown.

FIGURE 3: LIQUIDITY BURDEN AND CONTINUATION OF THE ENTERPRISE



70% (76,9%) of the professionals believe that the liquidity burden due to inheritance tax influences the future of an enterprise. The strength of this connection is evaluated by 60% (69,2%) as "very strong", "strong" and "rather strong" and can therefore be summarised as an overall strong connection.

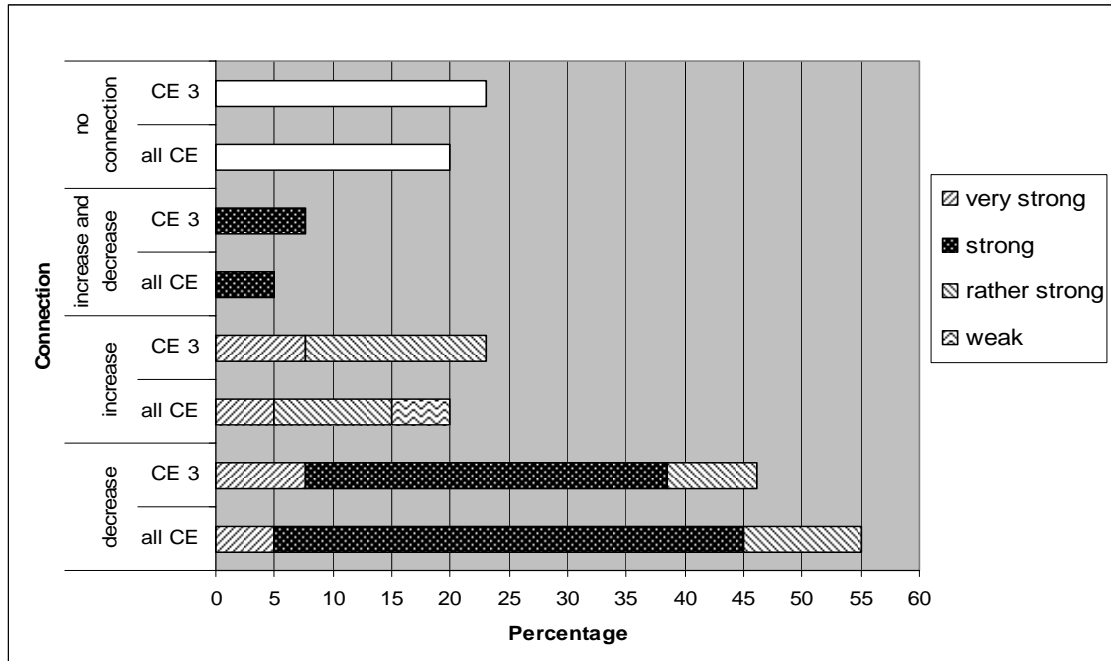
All participants who confirm a connection believe that the higher the liquidity burden, the more probable the termination of the enterprise at a later date will be. 30% (23,1%) are certain that there is no connection between the liquidity burden and the continuation or the termination of an enterprise.

5.2.3 Tax burden and volume of the transferred assets

One can assume that taxation reduces the motivation for asset accumulation in front of the business succession. The following figure 4 shows if the participants confirm a

connection between the level of the tax burden and the volume of the transferred assets and how strong this possible connection is.

FIGURE 4: TAX BURDEN AND VOLUME OF THE TRANSFERRED ASSETS



A connection between the level of the tax burden and the volume of the transferred assets is confirmed by 80% (76,9%) of the participants. 75% (76,9%) declare an overall strong connection by evaluating it as a "very strong", "strong" or "rather strong" connection.

While 55% (46,1%) explain that the volume of the transferred assets decreases when the level of the tax burden increases, 20% (23,1%) describe an increase of the transferred assets when the tax burden increases. The main argument for the decrease of the assets is that transferring business assets to the private property in front of the business succession will minimise the arising inheritance tax. 5% (7,7%) confirm that there is an increase as well as a decrease of the transferred assets if the tax burden is increasing. According to 20% (23,1%) of the participants there is no connection.

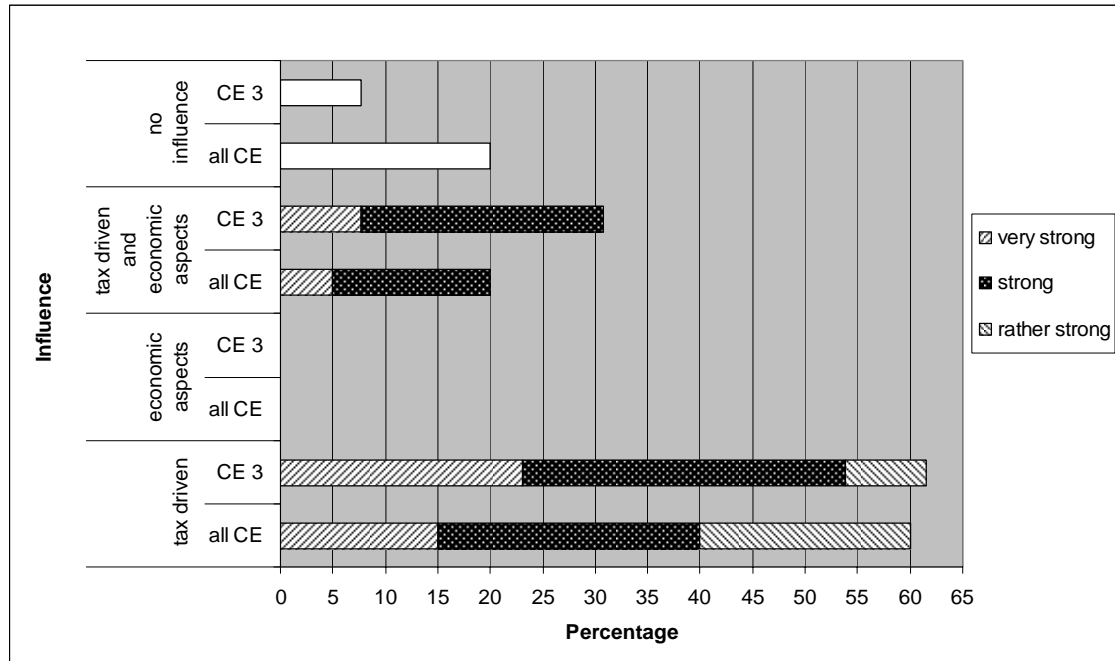
5.2.4 Tax burden and composition of the transferred assets

Figure 5 illustrates if the level of the tax burden influences the composition of the transferred assets. The question is whether the composition of assets has mainly the aim of optimising the economic position of an enterprise or of realising the lowest possible tax burden. Additionally the figure shows the strength of this possible influence.

80% (92,3%) of the participants have confirmed that there is an influence of the level of the tax burden to the composition of the transferred assets. They evaluate this influence as "very strong", "strong" and "rather strong", so there is an overall strong influence.

60% (61,5%) declare that the composition of the assets has the aim of realising the lowest possible tax burden. 20% (30,8%) confirm that the composition is tax driven but follows also economic aspects. No one of the interviewed tax professionals confirms solely economic aspects as relevant for the composition of the transferred assets. According to 20% (7,7%) of the participants there is no influence.

FIGURE 5: TAX BURDEN AND COMPOSITION OF THE TRANSFERRED ASSETS



5.2.5 Tax burden and willingness to move abroad

Fulfilling the requirements for avoidance of the British tax liability is difficult. However, the possibility of relocating abroad for tax reasons does exist. Figure 6 demonstrates if and how strong the level of the tax burden due to inheritance tax influences the willingness of taxpayers to move abroad to a country with lower taxes. In figure 7 it is shown how often the possibility of moving abroad is really carried out.

The majority of the participants, 80% (84,6%), verify a connection between the level of the tax burden and the willingness to move abroad. 45% (53,8%) evaluate this connection as "very strong", "strong" or "rather strong" and can be summarised as an overall strong connection. 20% (15,4%) negate a connection.

The survey shows that moving abroad is indeed often discussed among taxpayers, but occurs rarely. 80% (76,9%) of the interviewed tax professionals declare that moving abroad to a country with lower taxes is carried out seldom, very seldom or never. But 20% (23,1%) are of the opinion moving abroad for tax reasons occurs very often or sometimes.

FIGURE 6: TAX BURDEN AND WILLINGNESS TO MOVE ABROAD

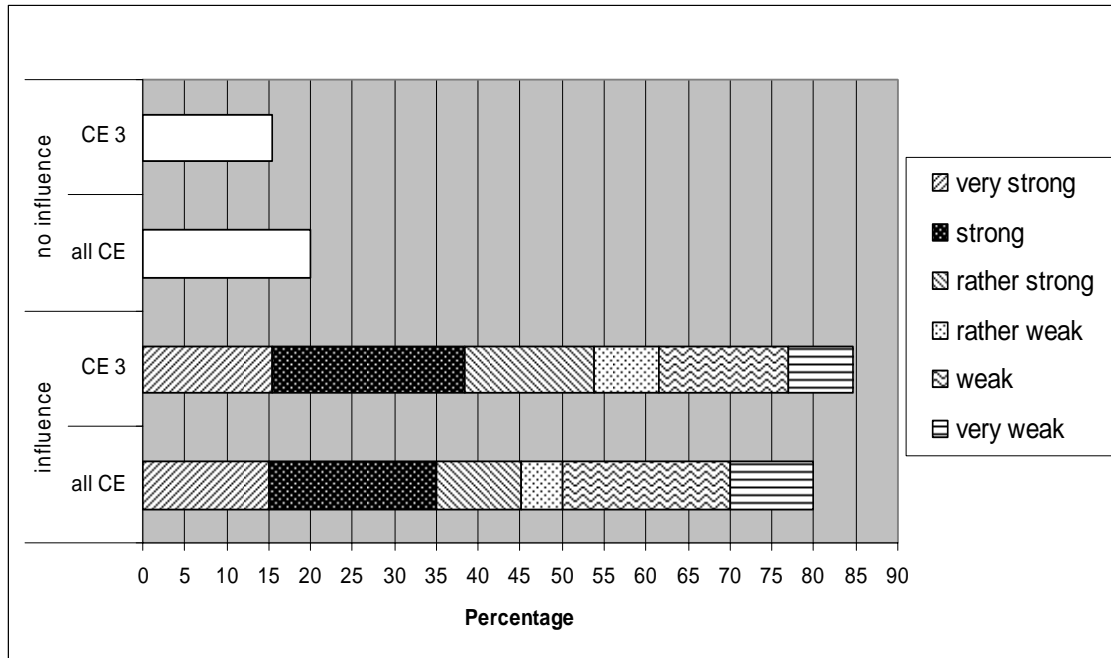
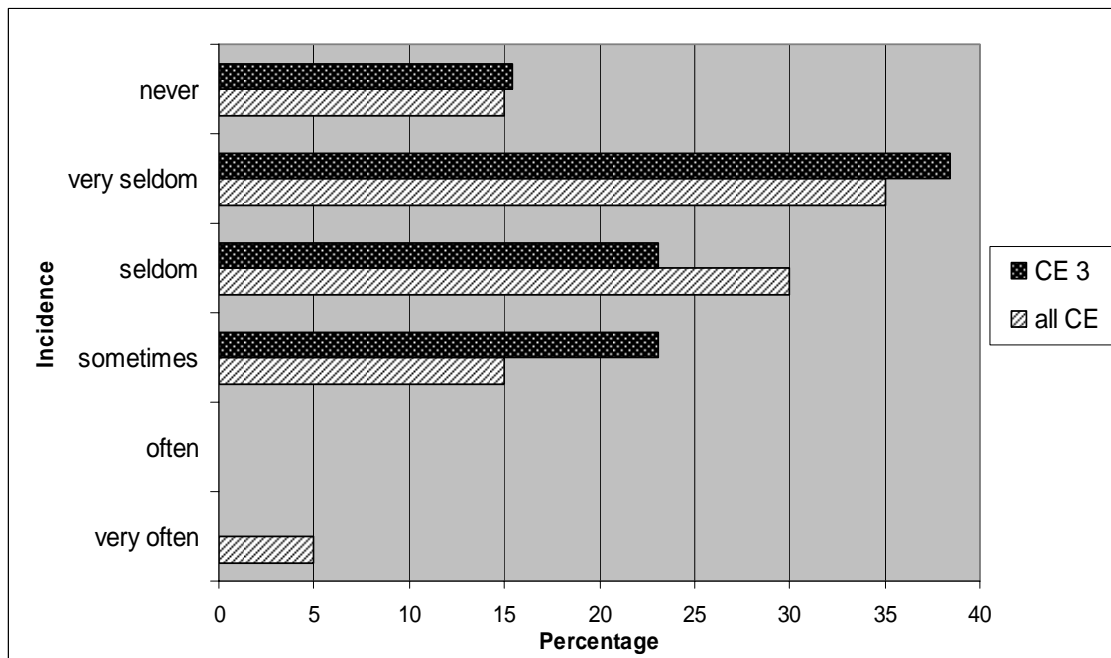


FIGURE 7: INCIDENCE OF MOVING ABROAD



5.2.6 Preferential treatment of business property to ensure business succession within the family

Figure 8 shows the personal opinion of the participants concerning the question if the preferential tax treatment on the transfer of business property is necessary to ensure the business succession within the family.

The preferential tax treatment on the transfer of business property to ensure the business succession within the family is confirmed by 90% (100%) of the interviewed tax professionals as a necessary measure. They evaluate the preferential tax treatment as "absolutely necessary", "necessary" or "rather necessary", and can be summarised as necessary overall. Only 10%, (solely participants who are categorised in CE 1 and 2), negate this necessity.

FIGURE 8: NECESSITY OF THE PREFERENTIAL TAX TREATMENT OF BUSINESS PROPERTY

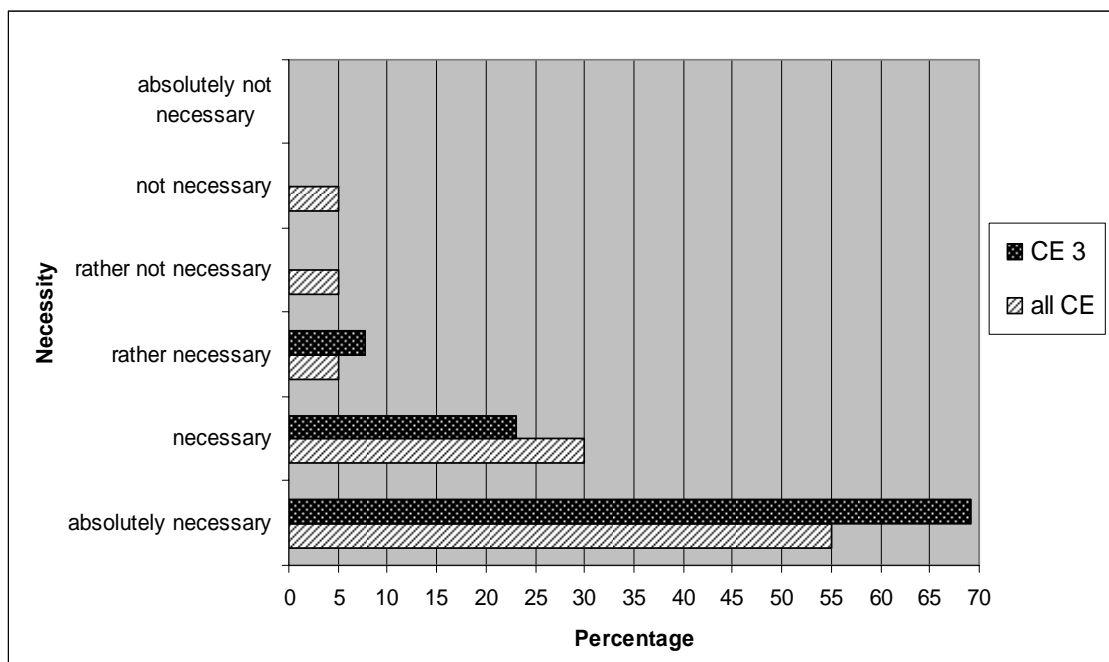
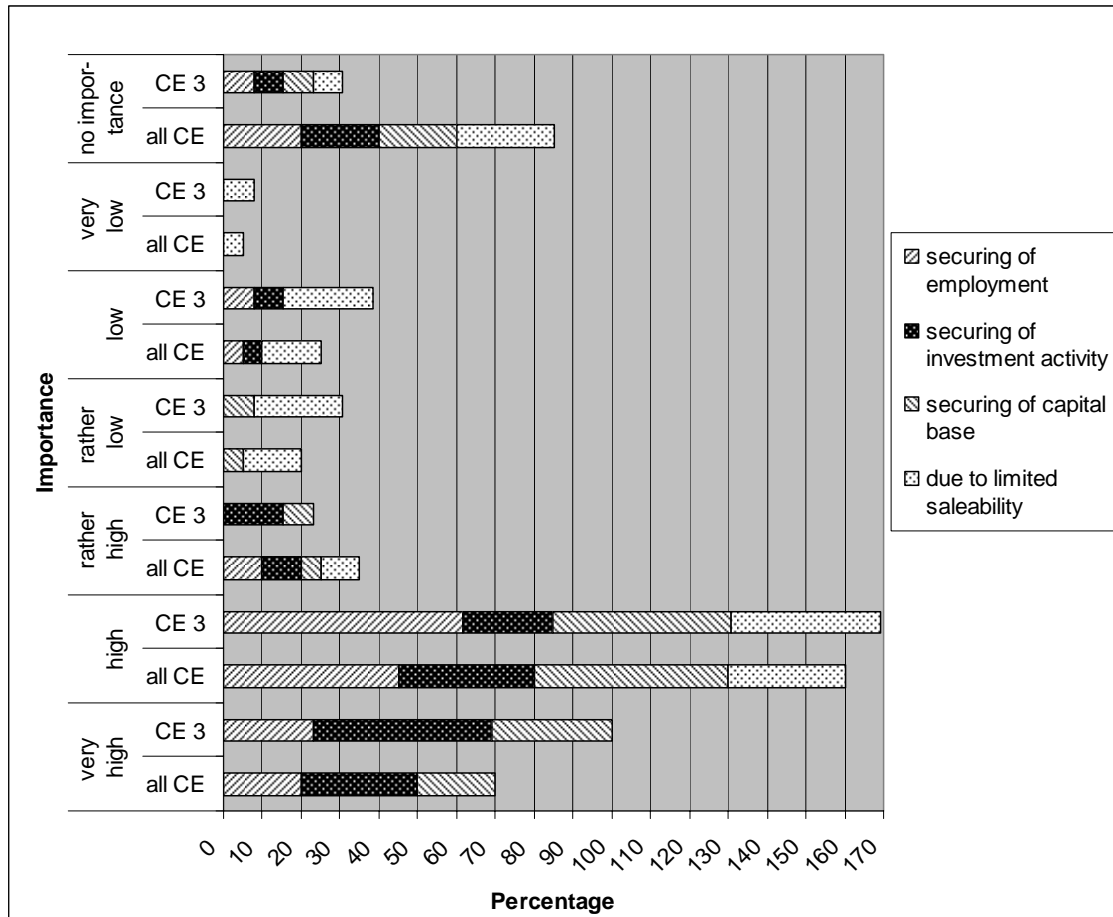


Figure 9 shows the reasons the participants mention as justification of a preferential tax treatment on the transfer of business property to ensure the business succession within the family. The level of importance of each reason is also shown in the figure.

Securing of employment, investment activity and capital base of a transferred enterprise as reasons for a preferential tax treatment are confirmed by 80% (92,3%) of the respondents. 75% (84,6%) evaluate each of these reasons as "very high", "high" and "rather high", showing they have an overall high importance.

The possible limited saleability of business property is seen as another reason for preferential tax treatment by 75% (92,3%) of the interviewed tax professionals. An overall high importance is confirmed by 40% (38,5%). 35% (53,8%) evaluate this reason as being of "rather low", "low" and "very low" importance. Based only on the evaluation of participants who are categorised in CE 3, this reason has an overall low importance.

FIGURE 9: REASONS AND IMPORTANCE OF A PREFERENTIAL TAX TREATMENT



5.3 Effects of specific regulations of the British Inheritance Tax Act

5.3.1 Potentially Exempt Transfers (PET)

Lifetime transfers are exempt from inheritance tax, if the donor survives at least seven years after the transfer, otherwise the transfer is taxed and the tax burden depends on the time lag between transfer and death. Figure 10 shows if there is a connection between this regulation of potentially exempt transfers and the timing when an enterprise is transferred to the successor.

All of the interviewed tax professionals confirm that there is a connection between PET and the timing of a transfer to the successor. The evaluations "very strong", "strong" and "rather strong" were given by 85% (84,6%) of the respondents, thus affirming an overall strong connection.

FIGURE 10: CONNECTION BETWEEN PET AND THE TIMING OF A TRANSFER

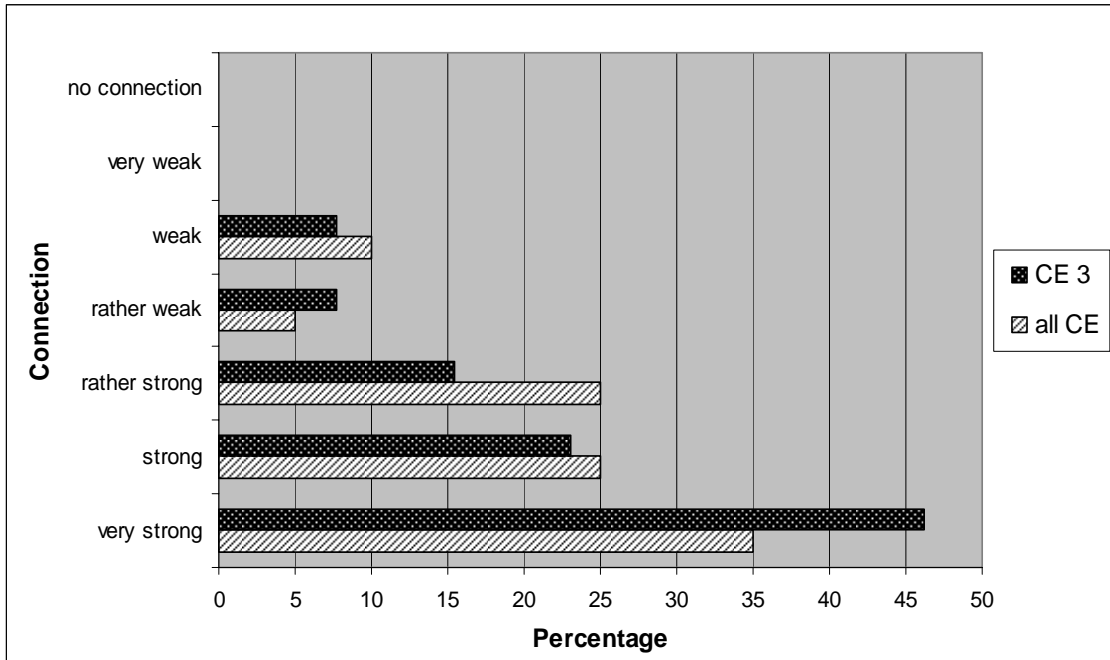
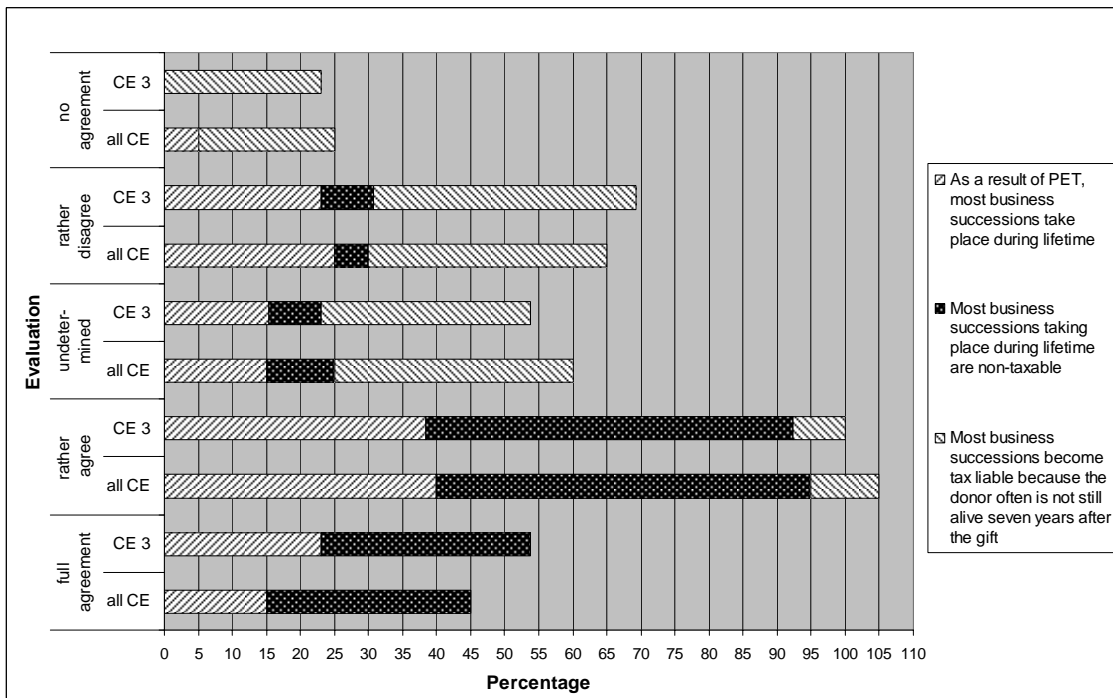


Figure 11 shows the evaluation of predetermined connections between PET and business succession. The level of agreement is used as standard of evaluation.

FIGURE 11: CONNECTIONS BETWEEN PET AND BUSINESS SUCCESSION



55% (61,5%) of the respondents fully or rather agree with the statement, that most business successions take place during lifetime as a result of PET. 15% (15,4%) explain that they are undetermined while 30% (23,1%) rather disagree or do not agree.

85% (84,6%) fully or rather agree with the statement, that most business successions taking place during lifetime are non-taxable because business property is transferred more than seven years before the death of the donor. 10% (7,7%) are undetermined and 5% (7,7%) rather disagree or do not agree.

The statement, that most business successions become tax liable because the donor often is not still alive seven years after the transfer, is rather agreed by 10% (7,7%). 55% (61,5%) however rather disagree while 35% (30,8%) are undetermined.

5.3.2 Business Property Relief (BPR)

The Business Property Relief differentiates between a full- or a half-tax exemption for specified property. The tax exemption is achieved through the reduction of the transferred value. Figure 12 shows if there is a connection between this regulation and business succession. Connection here means the importance of this regulation for business succession within the family.

All of the interviewed tax professionals confirm that a connection between a full- or a half-tax exemption and business succession does exist. 80% (76,9%) evaluate this connection as "very strong", "strong" or "rather strong", hence it can be summarised as an overall strong connection.

FIGURE 12: CONNECTION BETWEEN BPR AND BUSINESS SUCCESSION

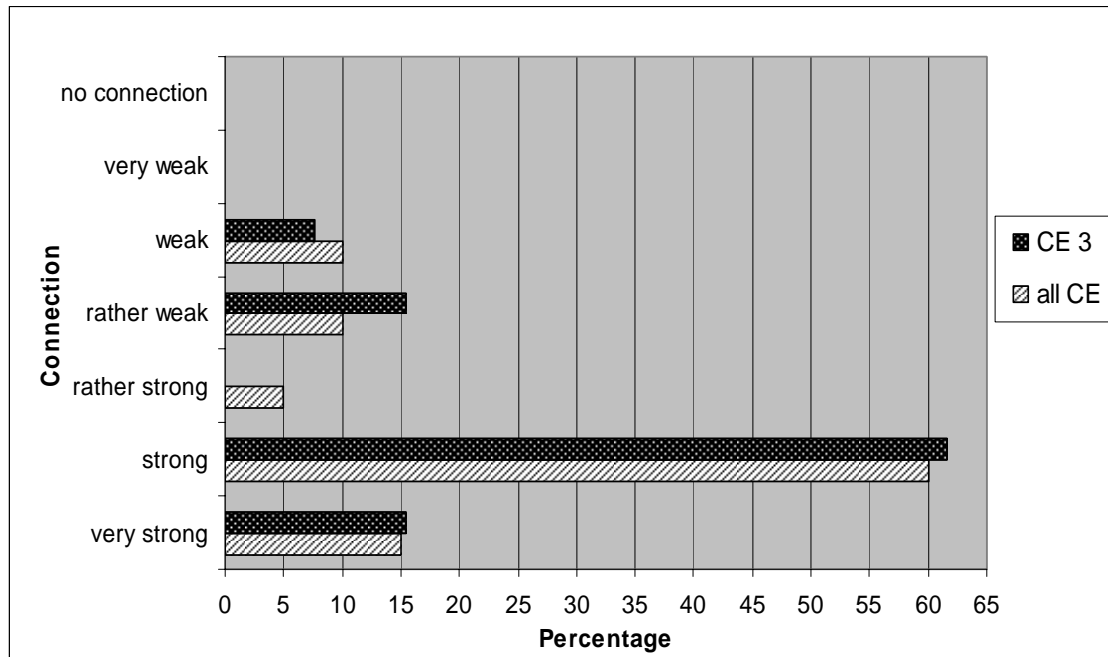
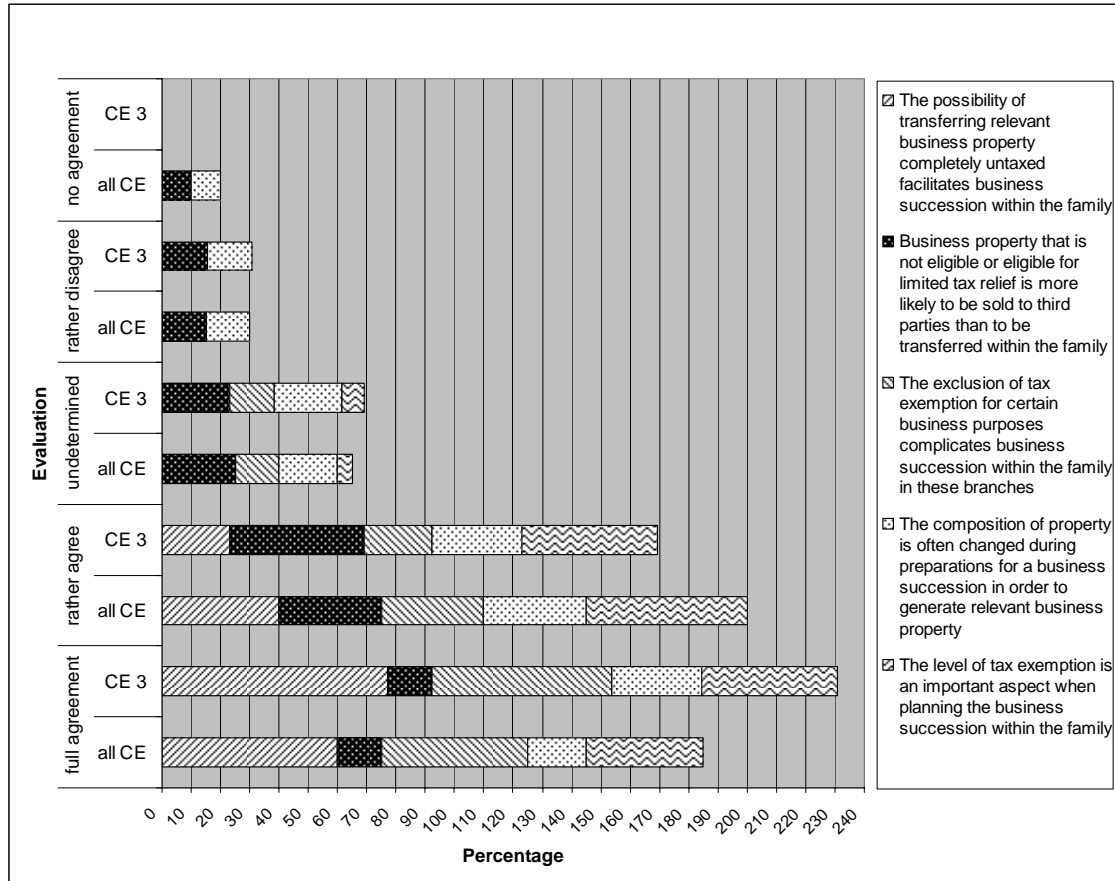


Figure 13 shows the evaluation of predetermined connections between BPR and business succession. The level of agreement is used as standard of evaluation.

FIGURE 13: CONNECTIONS BETWEEN BPR AND BUSINESS SUCCESSION



The statement, “that the possibility of transferring relevant business property completely untaxed facilitates the business succession within the family”, is fully or rather agreed by all of the participants.

50% (61,5%) of the respondents fully or rather agreed to the statement, “business property that is not eligible or eligible for limited tax relief is more likely to be sold to third parties than to be transferred within the family”. 25% (23,1%) are undetermined and 25% do not agree (15,4%).

85% (84,6%) of the respondents fully or rather agreed that “the exclusion of tax exemption for certain business purposes (dealing in securities, stocks or shares, land or buildings; making or holding investments) is fully or rather seen as complication for business succession within the family in these branches” . 15% (15,4%) were undetermined, but there was no disagreement with the statement.

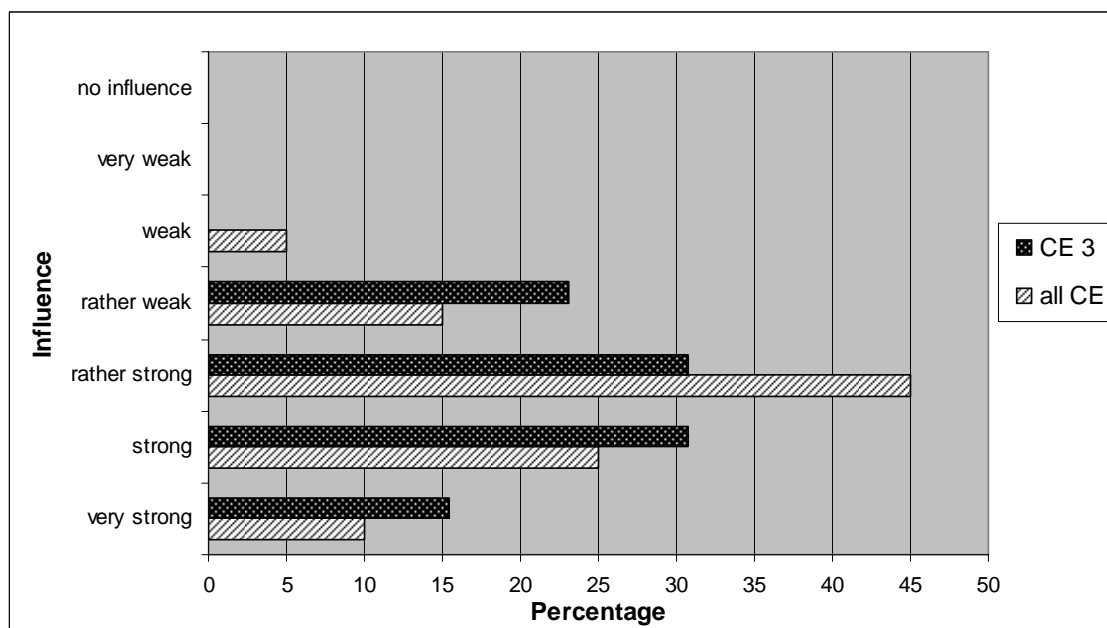
55% (61,5%) fully or rather agreed with the statement, “that the composition of business property is often changed during preparations for a business succession in order to generate non-taxable or partly taxable property”. 20% (23,1%) were undetermined, while 25% (15,4%) did not agree to this statement.

The level of tax exemption was evaluated as an important aspect by 95% (92,3%) of the interviewed tax professionals when planning the business succession within the family. The remaining 5% (7,7%) were undetermined, there was no disagreement.

5.3.3 Level of tax exemption of business property

The following figure shows the influence of the general level of tax exemption on business succession and the strength of this possible influence. “General level” means the division of business property into non-taxable or partially taxable (see BPR) and non-exempt (exempt property) business property. “Influence” means the importance of this differentiation for business succession within the family.

FIGURE 14: INFLUENCE OF LEVEL OF TAX EXEMPTION ON BUSINESS SUCCESSION



All respondents confirmed that the level of tax exemption influenced business succession. 80% (76,9%) evaluated this influence as "very strong", "strong" and "rather strong", and can be summarised as an overall strong influence.

Figure 15 shows the evaluation of the predetermined connections between the level of tax exemption (specific regulations) and business succession. The level of agreement is used as a standard of evaluation.

If the purpose of a transferred enterprise consists wholly or mainly in making or holding investments there is generally no tax exemption. But there is an exemption for holding companies, so that the BPR can be applicable. 55% (69,2%) of the respondents agreed fully or rather agreed to the statement, “this exception for holding companies facilitates the business succession of multi-level companies”. 45% (30,8%) were undetermined, there was no disagreement.

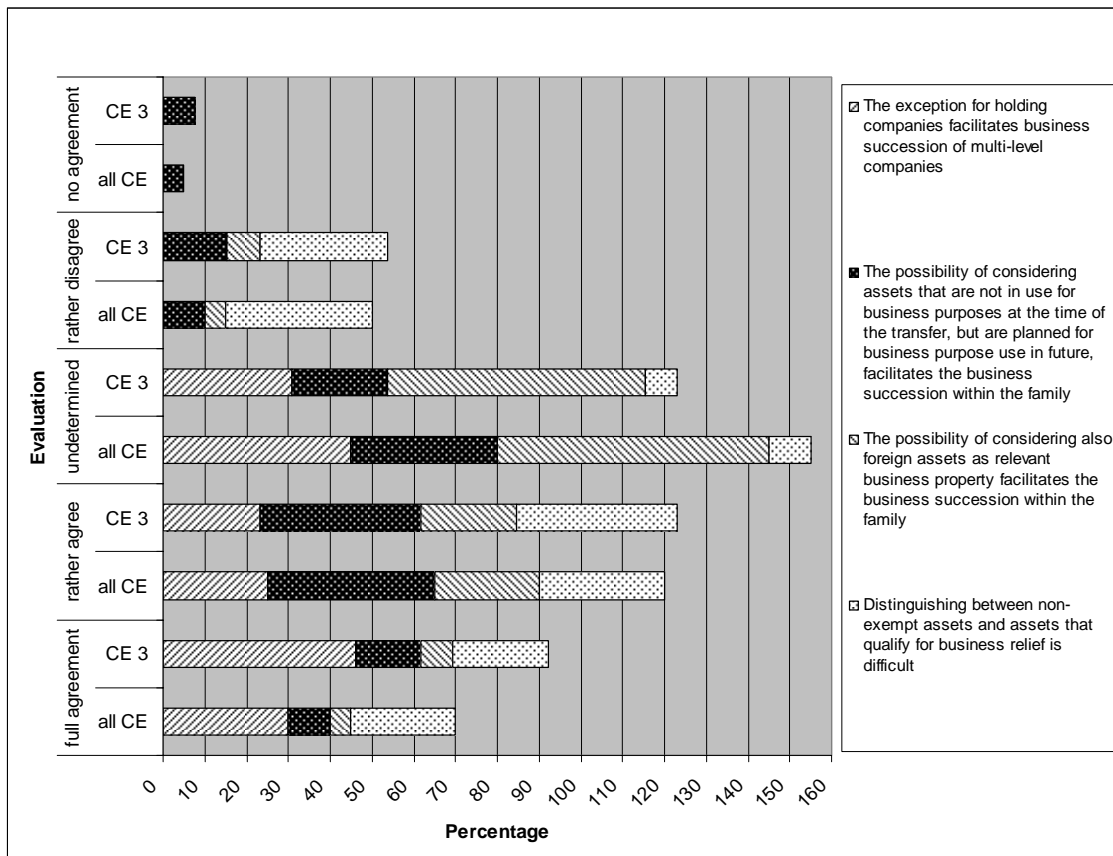
Property that is not used entrepreneurial is generally evaluated as excepted property with no tax exemption. But if such property is planned for business purpose use in future, the BPR can be applicable. According to 50% (53,8%) of the interviewed tax

professionals, this possibility facilitates business succession within the family. 35% (23,1%) were undetermined, while 15% (23,1%) did not agree.

The British preferential tax treatment of business property, (apart from in Germany), is not limited to domestic property. The statement, “that the possibility of considering also foreign assets as relevant business property facilitates business succession within the family”, was is fully or rather agreed by only 30% (30,8%) of the respondents. Most of the interviewed tax professionals, 65% (61,5%), of were undetermined and 5% (7,7%) did not agree.

The differentiation between business property that is available for a preferential tax treatment and business property that is taxed without an exception has to be done by using a so called wholly-or-mainly-test. This test has been developed because there is no fully legal definition that can be used to distinguish between non-exempt assets and assets that qualify for business relief. 55% (61,5%) of the participants have experience that this distinction is difficult, 10% (7,7%) are undetermined. According to 35% (30,8%) of the respondents, there is no difficulty distinguishing between non-exempt assets and assets that qualify for business relief.

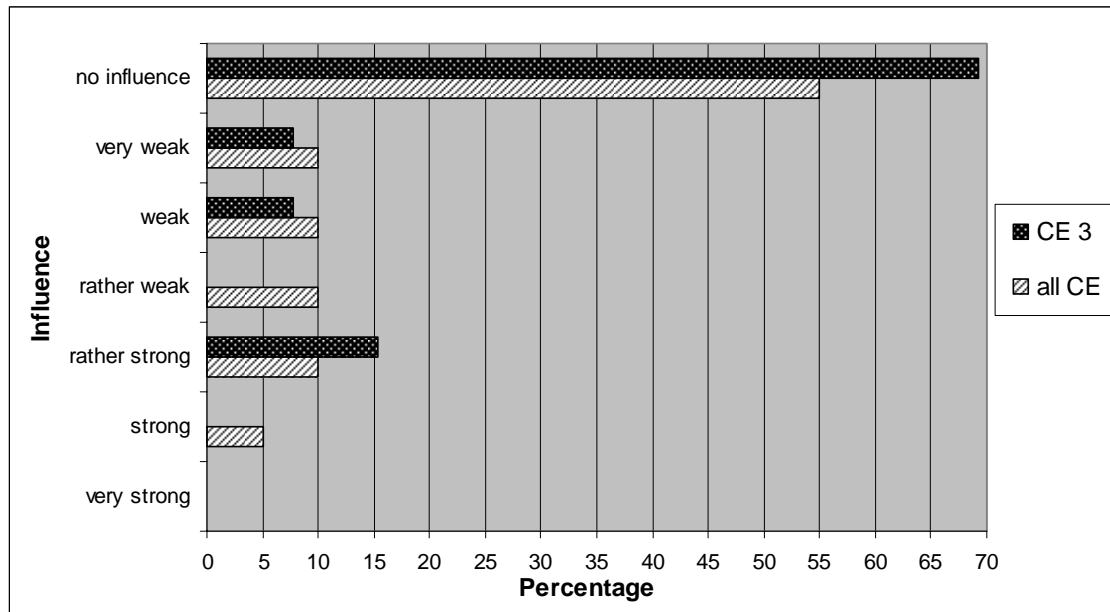
FIGURE 15: CONNECTIONS BETWEEN THE LEVEL OF TAX EXEMPTION AND BUSINESS SUCCESSION



5.3.4 Restriction of Potentially Exempt Transfers

When the transfer of business property is treated as PET, the tax exemption (BPR) lapses retroactively if the property is sold within seven years after the transfer and the donor died after the sale and within these seven years. Figure 16 shows the existence and the strength of a possible influence of this restriction to the willingness of a potential successor to assume the business succession.

FIGURE 16: RESTRICTION AND WILLINGNESS TO ASSUME A BUSINESS SUCCESSION



45% (30,8%) of the respondents confirm that the possible loss of the tax exemption to the willingness of a potential successor to assume the business succession. 15% (15,4%) evaluate this influence as "strong" and "rather strong". But most of the interviewed tax professionals, 55% (69,2%), do not have believe that this influence exists.

Figure 17 shows if the loss of the tax exemption does influence the continuation of the enterprise and how strong this possible influence is.

According to 70% (61,5%) of the respondents there is an influence of the loss of tax exemption to the continuation of an enterprise. 30% (30,8%) evaluate this influence with "strong" and "rather strong", but 30% (38,5%) do not believe experience that this influence exists.

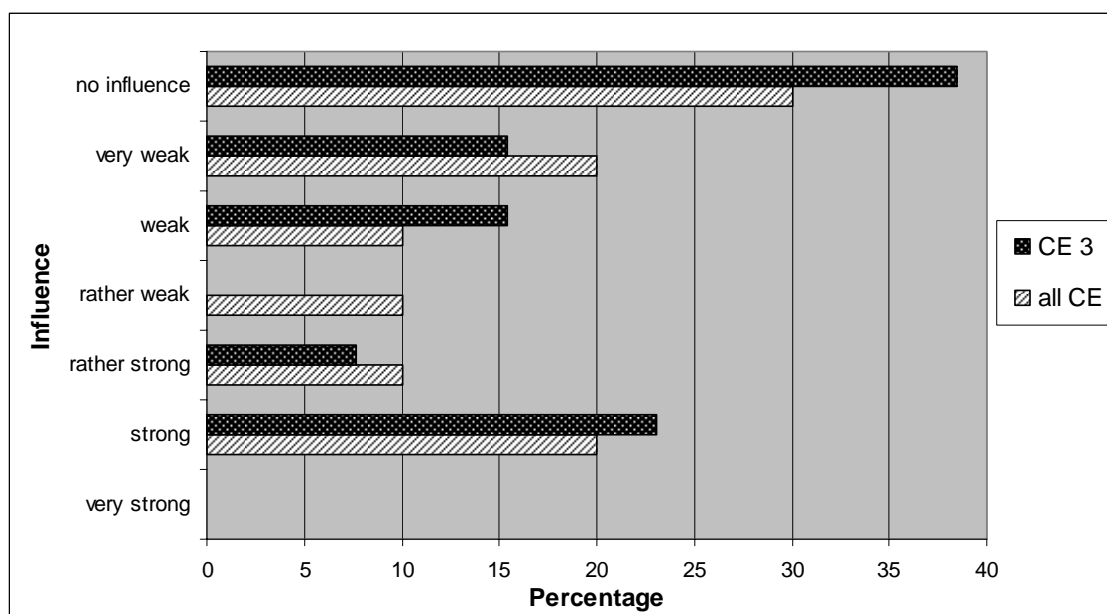
FIGURE 17: INFLUENCE OF THE LOSS OF TAX EXEMPTION TO THE CONTINUATION OF AN ENTERPRISE

Figure 18 shows the evaluation of predetermined connections between the possible implications mentioned above and business succession. The level of agreement is used as a standard of evaluation.

The statement, that the seven-year restriction period is a reason that a business succession is not assumed by the potential successor, was “rather agreed” by 15% of the respondents (but only participants who are categorised in CE 1 and 2). 15% (7,7%) were undetermined while 70% (92,3%) did not agree.

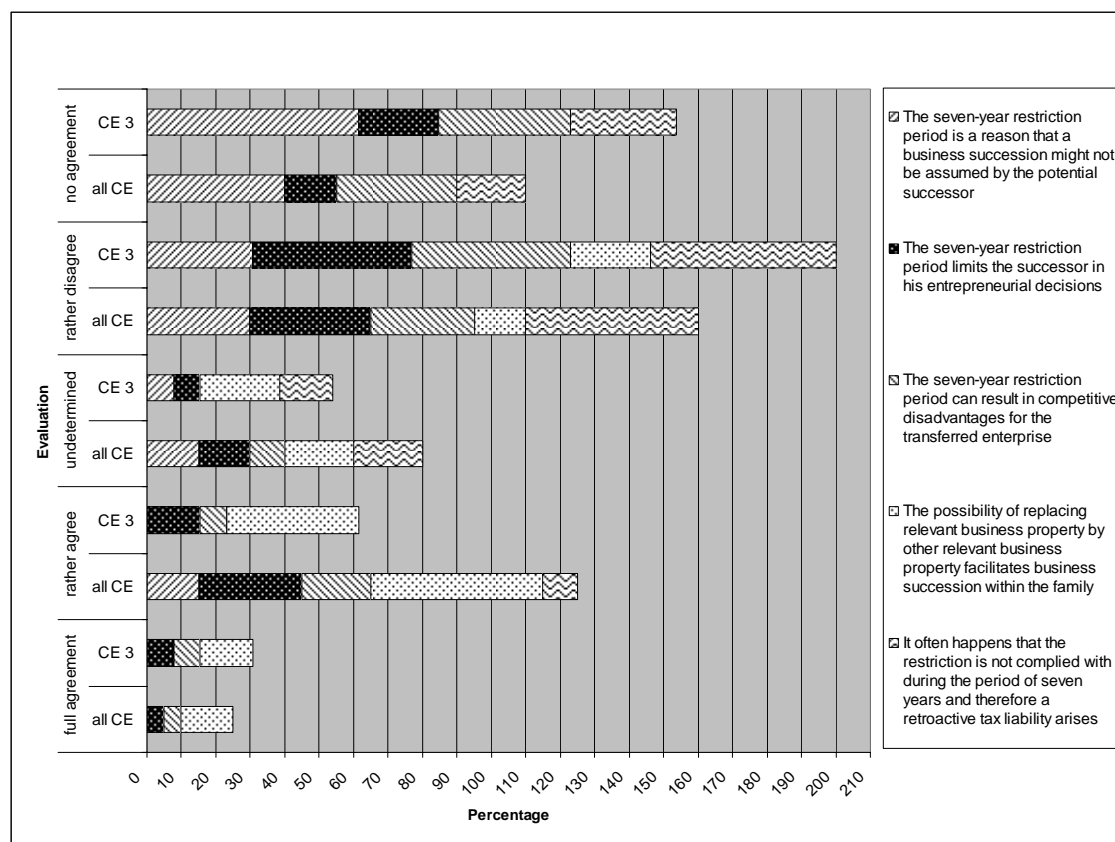
35% (23,1%) of the participants agreed that the seven-year restriction period limits the successor in his entrepreneurial decisions. 15% (7,7%) were undetermined and 50% (69,2%) did not agree.

The statement, “the seven-year restriction period can result in competitive disadvantages for the transferred enterprise”, was agreed by 25% (15,4%). 10% of the respondents, (only participants who were categorised in CE 1 and 2), were undetermined. 65% (84,6%) did not agree with the statement.

Relevant business property can be sold without a tax liability imposed if the sold property is replaced by other relevant property within one year after sale. 65% (53,8%) agreed that this possibility of reinvestment facilitates the business succession within the family. 20% (23,1%) were undetermined while 15% (23,1%) did not agree.

10% of the respondents (only participants who are categorised in CE 1 and 2) agreed that the restriction is often not complied with during the seven year period and a retroactive tax liability is imposed. 20% (15,4%) of the interviewed tax professionals were undetermined and 70% (84,6%) did not agree with this statement.

FIGURE 18: CONNECTIONS BETWEEN RESTRICTIONS OF PET AND BUSINESS SUCCESSION



6. SUMMARY AND DISCUSSION OF THE RESULTS

6.1 Fundamental Results

As general effects of the inheritance tax on business succession the survey has identified the following aspects:

- 1) There is no fundamental connection between the liquidity burden due to taxation and whether the business succession occurs within the family or by external succession. However, there are a significant number of cases where the liquidity burden has resulted in an external business succession.
- 2) There is a strong connection between the liquidity burden due to taxation and the continuation or termination of the enterprise after succession. The higher the liquidity burden, the higher the probability that there will be termination of the enterprise at a later date.
- 3) There is a strong connection between the level of the tax burden and the volume of the transferred assets. The volume decreases with the level of the tax burden.
- 4) The level of the tax burden does in fact influence the composition of the transferred assets. The composition has as a goal the lowest possible tax burden. Economic aspects are subordinated to this.

- 5) There is a strong connection between the willingness to move abroad to a country with lower taxes. However, the option to move abroad is rarely used.
- 6) Preferential tax treatment on the transfer of business property is absolutely necessary to ensure the business succession within the family, particularly to safeguard employment, investment activity, and capital base of the transferred enterprise.

As effects of specific regulations of the British Inheritance Tax Act on business succession it has been identified that:

- 1) The option of Potentially Exempt Transfers (IHTA 1984 s 3 A; 7 (4)) is an important incentive for the transfer of an enterprise during lifetime with the result that most business successions taking place during lifetime does not create any tax burden.
- 2) The Business Property Relief (IHTA 1984 s 104; 105) is very important to facilitate business succession within the family.
- 3) The risk that business property might be considered as non-tax exempt (IHTA 1984 s 112 (2)) hinders the business succession within the family.
- 4) The differentiation between relevant business property and property without a preferential tax treatment can be difficult.
- 5) The seven-year restriction period (IHTA 1984 s 113 A) influences neither the willingness to agree to a business succession nor the continuation of the enterprise.

These results are based on information of 20 participants respectively with the experience of at least 666 business successions. On this basis the results of the survey should be understood as first findings that have to be validated by further research. The existing database is currently improved by additional personal and written interviews with British tax professionals. However these first results can be used to investigate the effects of the British inheritance tax system on business succession that are expected during the hypothetical discussion (summarised in table 2) as one theoretical part of our research. The evaluation of the expected effects by using the first results mentioned above is shown in table 2. By using the first results most of the expected effects concerning inheritance tax and business succession can be confirmed.

It could be criticised that most of the expected effects are based on announcements that are perceptive. However to date there is no scientific knowledge concerning empirical effects of the inheritance tax on business succession. Further it has to be distinguished between simple awareness and scientific knowledge.⁷⁶

⁷⁶ See Kromrey, H. (2006), S. 17.

TABLE 2: EVALUATION OF THE EXPECTED EFFECTS

Expected effects	Confirmed	Partly confirmed	Not confirmed
The higher the liquidity burden due to taxation, the less probable is a business succession within the family.		X	
The higher the liquidity burden due to taxation, the less probable is the continuation of the enterprise within the family.	X		
The higher the level of the tax burden, the less the motivation for asset accumulation before the business succession.	X		
The taxation of business succession causes a composition of the transferred assets with the aim of the lowest possible tax burden.	X		
The higher the level of the tax burden, the more taxpayers move abroad to a country with lower taxes.			X
The potential tax exemption of lifetime transfers causes an early transfer of enterprise to the successors.	X		
The potential tax exemption of lifetime transfers ensures that most business transactions are non-taxable.	X		
The tax exemption for relevant business property facilitates the business succession within the family.	X		
The differentiation between relevant business property and property without a preferential tax treatment influences business succession within the family.	X		
Regulations for qualifying property without a preferential tax treatment as relevant business property facilitates business succession within the family.	X		
The restrictions of potentially exempt transfers have a negative influence to the willingness of the potential successor to assume the business succession.			X
The restrictions of potentially exempt transfers have a negative influence to the continuation of the enterprise within seven years after the transfer.		X	

The first results can be used to derive initial implications with reference to the conception or improvement of the legal framework. But further research has to be done before giving recommendations to the fiscal policy makers as to how to improve the existing tax systems.

One possible implication that can be mentioned is that the possibility of making lifetime transfers without inheritance tax could support the decision of an entrepreneur to transfer business property early. This effect should also be generated by the German legislation by using a similar instrument to generate an early responsibility of potential successors. The business retention restrictions that the preferential tax treatment generates do not have negative effects in regards to either the willingness of a potential successor to assume a business succession or to the economical situation of the enterprise. Therefore an obligation to retain the enterprise and keep it in progress would not be a disadvantage but could ensure the business succession within the family. However in the British tax system, (other than in German tax law), there are only a few cases where the restrictions are relevant (see chapter 5.3.4).

6.2 Methodological results

The results discussed in this paper are based on information of tax professionals who have participated in personal interviews.⁷⁷ To date the willingness of tax professionals to participate in the survey has been very low. One reason is that tax advisors and solicitors presently have large workloads because the legislator has announced further essential changes of the British tax law. This means that in many cases advisers would have required a form of financial compensation in order to participate in a survey. A further reason is the regional concentration of professionals who are working in the area of business succession consulting; most of them in cities like London, Manchester or Leeds. Other practitioners are often experienced only with private or agricultural property. This concentration of experience concerning business property requires a large amount of travelling to perform the personal interviews which means high travelling costs and a time gap between the interviews, which limits the number of possible interviews.

It can be summarised that there is a high financial effort to generate the relevant data, but the methodology that has been chosen in this research work seems to be adequate to generate information about the real effect of inheritance tax on business succession.

7 FURTHER RESEARCH

Empirical research concerning the question of how tax systems could influence the decision making of people is not common in the field of tax research. This paper should reveal that empirical methods are suitable for generating knowledge in the area of behavioural taxation. As a first step of our research the survey was limited to tax advisors as participants of personal interviews to examine if this first generated database is exploitable for deducting positive and negative effects of the British inheritance tax system to business succession decisions. Therefore our manuscript is characterized as an initial study that should evaluate this type of research in general by using the current German inheritance tax reform bill as practical research background.

The now existing database has to be enlarged to ensure evidence with high validity which enables a deeper evaluation of the positive and negative effects of the British inheritance tax system. In the future there will be further personal interviews in Great Britain to increase the number of participants. Additionally there will be a written survey among the British members of the Family Business Interest Group of STEP and further institutions.

As a second validation measure it is planned to perform personal interviews with entrepreneurs who are planning to transfer their business property to a successor. A further group of participants will be offered by entrepreneurs who have already taken over an enterprise. There are first connections to institutions like the Institute of Family Business (IFB) in London that is the British chapter of the International Family Business Network.

⁷⁷ Most of the interviews have been arranged by the Applied Research Group in Taxation, Coventry University Law School.

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