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RESEARCH LETTER #2

EFFECTS OF SUCCESSION TAXES AND INHERITANCE LAWS ON INVESTMENT OF FAMILY BUSINESSES

Recent academic research has shown a growing interest in how family businesses interact with tax and inheritance policies. Two key studies delve into this area, providing important insights into how external regulations affect the decisions and investments of family firms.

- Tsoutsoura (2015) examines the impact of succession taxes on family businesses in Greece. Using a tax reform in 2002 as a natural experiment, Tsoutsoura demonstrates how fiscal policies influence the investment decisions of family-owned businesses, particularly during ownership succession.

- Ellul et al. (2010) analyze inheritance laws across 38 countries. Their research reveals how rigid inheritance laws, especially in regions with weaker investor protection, can limit the investment opportunities for family firms. Their work highlights the significant role legal frameworks play in shaping the operational and financial strategies of family enterprises.

Together, these studies enhance our understanding of family businesses. Tsoutsoura's study focuses on the impact of taxation policies within a single-country context, while Ellul and colleagues offer a broader perspective across countries. Both studies emphasize the complex ways in which external fiscal and legal environments can either hinder or support the growth and sustainability of family businesses.

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EFFECTS OF SUCCESSION TAXES AND INHERITANCE LAWS ON INVESTMENT

The 2002 Greek succession tax reform and family firm investments (Tsoutsoura, 2015)

In 2002, the Greek Law N.3091 led to a significant reduction in succession taxes for transfers of limited liability firms within the family, whether through inter vivos transfers, gifts, or inheritances after death. Specifically, starting January 1, 2003, the tax rate decreased to 1.2% for transfers to first-degree relatives (such as siblings, spouses, parents, or offspring) and 2.4% for transfers to second-degree relatives (like grandchildren, nephews, or nieces). However, the tax rate for transfers to unrelated third parties remained unchanged at 20%.

Before the implementation of Law N.3091, tax rates were considerably higher. Inter vivos transfers of limited liability companies incurred a flat rate of 20% tax, regardless of whether the transfer was to family members or unrelated third parties. In cases of gifts or inheritances to first-degree family members, the tax rate was 15% for amounts between 28,000 and 131,000 euros, and 25% for amounts exceeding 131,000 euros. For transfers to other family members, the rates were 20% and 35%, respectively.

Succession tax strain: limiting family firm investment

High succession taxes create a significant economic burden for family-owned businesses, especially during ownership transitions. These taxes may deplete financial resources or necessitate asset sales to meet tax obligations, limiting capital for reinvestment. This strain likely fosters a conservative investment approach as firms anticipate tax impacts.

High succession taxes restrict family firms' choices, curbing reinvestment and promoting cautious investment strategies.

Additionally, high succession tax anticipation may influence control transfer decisions within families, potentially prompting sales rather than family retention. The 2002 Greek tax reform aimed to reduce these constraints, allowing family firms more freedom for growth.

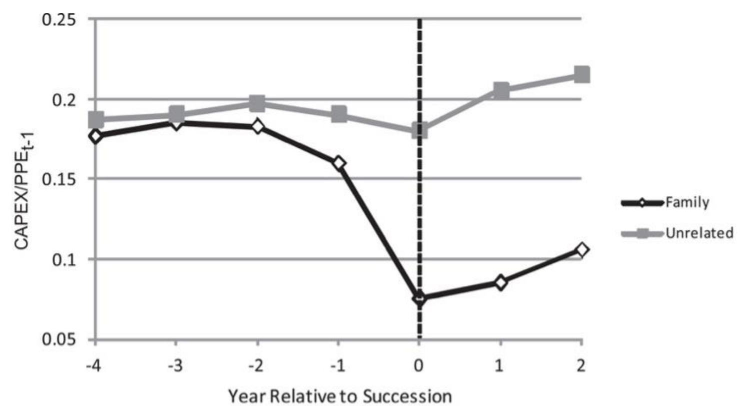
In order to identify the effect of succession tax on firm policies, Tsoutsoura uses an extensive dataset on all transfers of limited liability companies within Greece from 1999 to 2005. The focus is on 694 inter vivos successions, deliberately excluding firms in the utilities and financial sectors to avoid sector-specific distortions.

The results reveal a significant decline in investment levels in family firms around succession events when faced with high succession taxes. Figure 1 focuses on successions that occurred around the tax reform. Here, time is referenced in years, centered around the transition year.

In the presence of high inheritance taxes, investment around family business transfers falls by 40%.

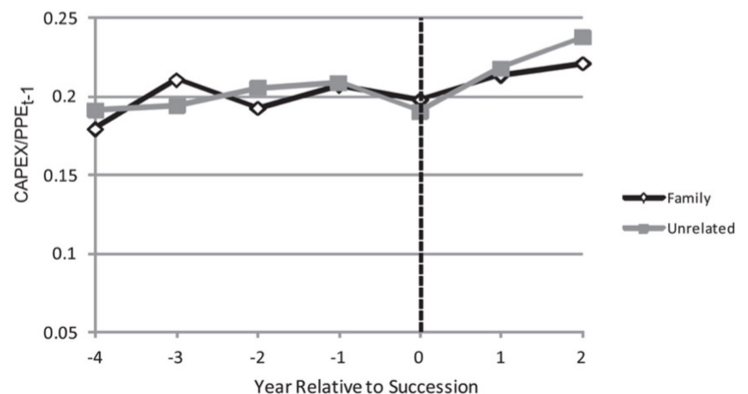
Panel A illustrates that firms undergoing family transfers, when subject to high succession taxes, exhibit a significant investment reduction in the succession year compared to those transferred outside the family.
This investment drop for family succession firms exceeds 40% from the level before the transition and continues for at least two years post-succession.

Figure 1.A Investment (CAPEX/PPE_{t-1})



Panel A: Before the Tax Reform (High Tax for Both Family and Unrelated Successions)

Panel B displays the average investment trends surrounding succession events for both family and unrelated successions happening after the reform. Differing from Panel A, Panel B indicates that with the substantial reduction in succession taxes for family transfers, the investment trends of family firms and those with unrelated successions start to align more closely.



Panel B: After the Tax Reform (Low Tax for Family Successions)

Note: Successions are classified into two categories: family, when the transfer of the firm is to relatives of the first or second degree, and unrelated otherwise. Time is measured in years relative to the year of transition.
Source : Tsoutsoura (2015).

After the 2002 Greek tax reform, family successions in firm transfers surged from 45.2% to 73.9%, showing a clear response to reduced tax rates. The study highlights stronger tax impacts on family firms with low asset tangibility and those owned by entrepreneurs with limited alternative income sources.

Inheritance law and investment in family firms (Ellul et al., 2010)

Stringent inheritance laws, which require a certain portion of an estate to be inherited by non-controlling heirs, can significantly restrain the operational and investment flexibility of family-owned businesses. Such laws could limit the available capital for reinvestment by earmarking a portion of the business's assets for inheritance. This is particularly impactful in countries where these laws are more inflexible, as family firms face heightened capital constraints due to the obligatory asset distribution to heirs. This constraint is further exacerbated in jurisdictions with lower levels of investor protection, where external financing is more difficult to obtain, thus intensifying the investment limitations that these firms face.

Ellul, Pagano, and Panunzi's research aims to empirically validate these mechanisms, examining how these legal mandates interact with financial resource allocation to influence the investment decisions of family firms in different legal environments.

The permissiveness of inheritance law worldwide

Inheritance laws vary globally, with some jurisdictions enforcing more equal distribution among heirs, while others allow more freedom in asset allocation. Ellul et al. (2010) introduce an indicator measuring inheritance law permissiveness worldwide. They find that common law countries generally have more permissive laws compared to civil law countries. For example, in civil law countries, the maximum share left to a child in the presence of a surviving spouse is 60% for two children and 54% for three, whereas in common law countries, it's 96% for both cases (Table 1).

Common law countries generally allow more freedom in asset allocation among heirs compared to civil law countries

Table 1. Inheritance law permissiveness

A. Civil Law	**Without Spouse**		**With Spouse**	
	2 Children	3 Children	2 Children	3 Children
Average	0,72	0,63	0,60	0,54
Standard Err	0,09	0,12	0,15	0,16
(France)	*0,66*	*0,50*	*0,66*	*0,50*
B. Common law	**Without Spouse**		**With Spouse**	
	2 Children	3 Children	2 Children	3 Children
Moyenne	1	1	0,96	0,96
Ecart-Type	0	0	0,12	0,12
(USA)	*1*	*1*	*1*	*1*

Notes: Panel A presents descriptive statistics on the maximum share that can be bequeathed to a single child in the absence or presence of a surviving spouse, for 2 or 3 children in civil law countries. Panel B offers the same statistics for common law countries.
Source: Ellul et al. (2010).

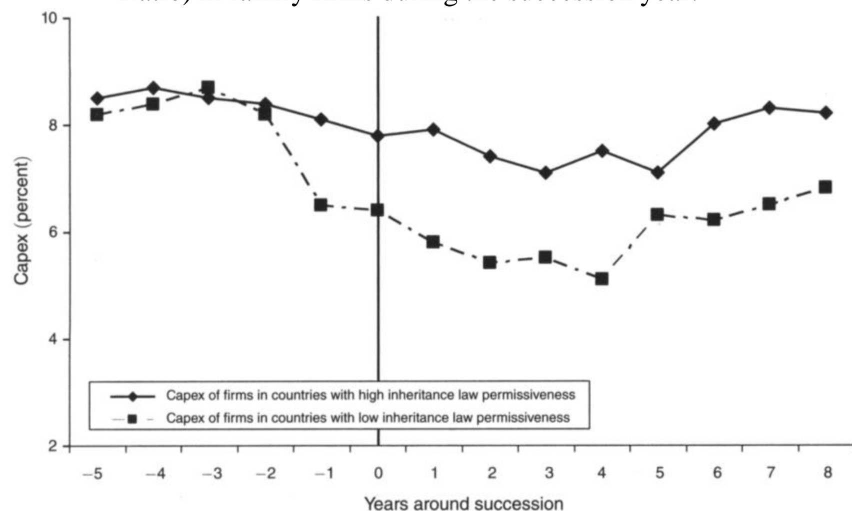
Succession in countries with different degree of inheritance law permissiveness

Drawing upon financial and accounting data sourced from Worldscope and Compustat databases, the study spans 38 countries and includes 10,000 listed companies, with 3,157 of them being family-owned businesses (at threshold of 20%).

Figure 2 illustrates the average Capex ratio for the 952 family firms experiencing in-family succession, divided into two subgroups based on inheritance law permissiveness. Countries with strict inheritance laws witness a significant decrease in investment ratio: from 0.079 in the five years before succession to 0.057 in the subsequent nine years. Conversely, in countries with permissive inheritance laws, the mean Capex ratio only decreases from 0.086 to 0.079, which is not statistically significant.

In countries with strict inheritance laws, family firms exhibit lower investment levels around successions compared to firms in countries with more lenient inheritance laws....

Figure 2. Investment (Capital Expenditure to Total Assets Ratio) in family firms during the succession year:



Source: Ellul et al. (2010).

In countries with stricter inheritance laws, family firms exhibit lower investment levels compared to those in countries with more lenient laws. Ellul et al., 2010 show that this trend is more pronounced in countries with weaker investor protection, indicating that restrictive inheritance laws coupled with limited external financing exacerbate investment challenges for family firms.

... a trend more pronounced in countries with weaker investor protection

Unlike non-family firms, family businesses are uniquely susceptible to the constraints of inheritance laws. Moreover, the impact of inheritance laws on investment is particularly significant in the context of business succession, where legal requirements for estate division are most relevant.

References

Ellul, A., Pagano, M. and Panunzi, F., 2010. Inheritance law and investment in family firms. *American Economic Review*, *100*(5), pp.2414-2450.

Tsoutsoura, M., 2015. The effect of succession taxes on family firm investment: Evidence from a natural experiment. *The Journal of Finance*, *70*(2), pp.649-688.

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FAMILY BUSINESS AND LONG-TERM INVESTMENT

Developing research on family-owned companies and their dynamics

Family businesses at all levels - global, European, and French - represent a significant portion of the economy in terms of numbers and business share.

What are these companies' performance, strategies, economic and social models? Are they equipped to meet the challenges of ongoing digital and environmental transitions? These are the questions that the new “Family Businesses and Long-Term Investment” Chair at the University Paris Dauphine - PSL aims to address.

This Chair is affiliated with the Dauphine Research in Management Laboratory (DRM) and the Dauphine Research in Economics Laboratory (LEDA).

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