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A short overview of the Business Tax Reform in Germany

One of the most ambitious projects of Germany's Grand Coalition which ruled the country from 2005 to 2009 was the reform of the business tax system which had been considered as to be one of the systems with the highest tax rates on business earnings. The main aspects of the new law are the reduction of the tax rate of corporation tax, the creation of a financing expenditure ceiling rule and a flat tax for income on capital earned by non-professional contributors of capital.



The bill passed legislation in July 2007. Most new regulations have become effective in the tax year 2008. At the end of 2008, the global financial and economic crisis reached Germany like most other countries. The government answered these challenges by introducing some temporary reliefs that at a certain extent took back some of the changes.

The German National Elections on 27 September 2009 ended with the creation of a government which consists of Christian Democrats and the Liberal Party (FDP). The latter one was strongly opposed to the reforms of business taxes delivered by the Grand Coalition. But the new government will not totally abolish the changes made by its predecessor. The three parties that now form the Federal government (CDU, CSU, FDP) have voted for a law destined to stimulate the economic growth by introducing some tax incentives and stopping the limitations of some reliefs which have been introduced by the last government for the economic recovery. These modifications will become operative at the beginning of 2010.

Although the tax rate of the corporation tax was 25 % before 2008, there were many calls for a reduction because enterprises did not only have to pay this tax but in addition a solidarity surcharge of 5.5 % on income and corporation tax and a trade tax which lead to an overall tax burden of nearly 39 %. From 2008, it has dropped to 29 to 30 %.

There is no common business tax in Germany. Earnings of corporations such as stock

corporations and limited companies (GmbH) are subject to the corporation tax, whereas earnings of partnerships are taxable income of the associates or partners and subject to the income tax. The same applies to sole proprietorships. Tax rates of income tax vary from 15 to 45 %. The solidarity surcharge was introduced as an additional source for the financing of the German reunification but these tax revenues flow into the national budget and are used for multiple purposes. The surcharge consists of an extra charge of 5.5 % on the income or corporate tax. Municipalities have strong sympathies for the trade tax because most revenues of it go to them.

Subject of the trade tax is the profit of an enterprise and certain factors heighten the profit and some factors reduce it. Corporations pay a trade tax which will be worked out as follows: 3.5 % of the profit will be multiplied with a certain percentage rate which is at least 200 %. Municipalities are authorized to establish the rates at which taxes on real property and trades are levied, so each municipality defines the multiplier on its own. Big towns have multipliers today higher than 400 %. An example: A company gains a profit of 1,000,000 EUR. 35,000 EUR (3.5 % of a million) have to be multiplied with 4.2 (multiplier 420 %) which makes a burden of 147,000 EUR. The trade tax reduces to a certain extent the income or corporation tax (3.8 of the profit before multiplication, in this case 133,000 EUR. The reform has raised the factor from 1.8 to 3.8).

With the beginning of 2008, the tax rate of the corporation tax has dropped from 25 to 15 %. One has to say that the main principle of the new reform is to reduce the tax burden in tandem with the diminishing of tax exemptions and reliefs and the broadening of the taxable base. In the old system, not a few companies were inclined to finance the company by credits from subsidiary companies abroad and to demand the recognition of the interests paid for the credits as expenses allowed for tax

purposes or firms transferred earnings to allied companies in another country. It is the aim of the new bill to make Germany more competitive on the international fiscal scene and to keep taxable profits in the country.

In the first year of the coming into effect the government was expecting a deficiency in receipts of five billion euros, but politicians said that this deficit would be compensated for a big part in the long run.

The changes of the Business Tax Reform Act in detail:

- The **corporation tax rate** has been lowered from 25 to 15 % at the beginning of 2008.
- The **trade tax** has to be offset against the income or corporation tax to a much higher extent. Only 3.5 % of the earnings will be taken into account and multiplied with the tax rate of the particular municipality, in the old system the percentage rate varied from 1 to 5 percent. The offset is limited by the trade tax paid in fact. The additional amounts to the earning only apply to earnings exceeding a tax exemption of 100,000 EUR but all kinds of financing with outside capital are covered. In the new system it is not possible to handle the paid trade tax as a deductible expense against income or corporation tax.
- Introduction of an **interest deduction ceiling**. In general, interests paid by an enterprise for credits granted to the enterprise are business expenses and belittle the company's profit and therefore the actual tax load. The new law limits the tax deductibility of interests. Interests for credits to the company may be deducted entirely if they do not pass the sum of interests the company earns for money lent to other establishments. Finance authorities will compare the interest expenditures with the interests earned (interest surplus). If the latter are lower than the expenditures, interest expenditures can only be taken into account to the extent of 30 % of the company's profit, increased by interest

expenditures and reduced by interest earnings. The new law which will become effective at the beginning of 2010 describes this sum as the **clearable EBITDA** (*earnings before interest, taxes, depreciation and amortization*). It consists of 30 % of the sum of earnings, net interest debit and depreciations. If the clearable EBITDA is higher than the interest expenditures reduced by the interest revenues, the not exhausted part has to be carried over into the next five years (this carry-over will not be realized if the escape clause is applicable).

There is an escape clause which excludes some enterprises from the financing expenditure ceiling rule. It is not applicable to enterprises with an interest surplus smaller than three million euros or to companies that are not or not entirely part of an affiliated group or to allied companies whose equity ratio of the last year was as high or even higher as the ratio of the affiliated group.

Firms have to deal with the interest deduction ceiling with financial years beginning later than 25 May 2007 and ending not before 1 January 2008.

Originally the tax exemption was one million euros but in June 2009 the German parliament, the Bundestag, passed a law that raised the interest deduction ceiling rule up to three million euros. This modification was limited until 2010 but the new political majority lifted this limitation by a new law.

- **Preferential treatment of retained profits:** The taxation of retained profits of enterprises subject to the income tax has been adjusted to the taxation of retained profits of corporations. If the tax payer demands, the retained profit will be taxed with a rate of 28.25 % plus solidarity surcharge and not with the individual income tax rate which can be higher (up to 45 %). In case the so privileged gain is taken out of the firm's assets there will be a subsequent taxation of 25 % plus surcharge. These regulations do not apply to enterprises that record financial transactions by single-entry bookkeeping.
- **Abolishment of the declining depreciation:** But it will still be possible to depreciate on a straight-line basis. The old regulation may still be used for assets acquired before 1 January 2008. *As a step against the influences of the international finance crisis, declining depreciation has been reintroduced temporarily for the years 2009 and 2010 (but it is limited up to two and a half of the linear depreciation, maximum 25 %).*
- **Immediate write-off:** The immediate write-off of low-value assets has been restricted to assets with a value not higher than 150 euros in the years 2008 and 2009. Goods with values higher than 150 euros and less than 1,000 euros have to be placed in a compound item which melts off in the next five years. All assets acquired after 31 December 2007 are subject to these regulations. *From 2010, immediate write-off will return due to the new political majority. Expenditures for the acquirement of low-value assets with a value not higher than 410 euros are totally operational expenditures in the year of the purchase. Assets under 150 euros value have to be listed in a special account. Alternatively it is possible to place low-value assets with a value more than 100 euros and not more than 1,000 euros in a compound item that has to be dissolved in the year of the purchase and in the following four years with a fifth a year.*
- **Special depreciations and early depreciations** for goods acquired in the future will be facilitated for smaller establishments. Enterprises may make higher earnings in 2009 and 2010 in order to benefit from these regulations.
- **New regulations of the taxation of shell companies:** A shell company may be described as an incorporated company whose business transactions have come to an end so that another firm takes it over in order to use the losses of the taken enterprise as a carryover reducing the tax burden of the absorbing firm. If more than 25 and not more than 50 % of the shares of the shell company are controlled, the carryover is restricted partially. If more than 50 % of the shares are bought, the purchaser may not carry over the losses of the shell company.

As a further step against the economy crisis, the German parliament introduced a clause for the recapitalisation of a firm in June 2009. This clause would have disabled the application of the regulations mentioned above if the shell company had continued its business activities and had not crossed its industry lines. A nonperforming company would have been allowed to offset losses against profits in the future despite the changes of the ownership. But the Commission of the European Union considers this clause as incompatible with the Treaty of the European Union as it creates an improper financial aid for ailing companies (decision of 26 January 2011 C 7/2010). The German fiscal authorities are obliged to claim the taxes that were not paid due to this clause. On 9 January 2011 the German Ministry of Finance announced that it would ask the General Court of the European Union to check the lawfulness of the Commission's decision. This action for nullification will have no suspensive effect which means that tax authorities will have to recall financial tax allowances granted by this clause. There will be some exceptional cases.

The changes of the business tax reform of the end of 2009 contain a clause which allows the loss to be carried forward if there is a regrouping within an affiliated group. From 2010 on, there is no harmful acquisition if one person holds 100 % of the shares of the buyer and the bought company. This clause will not be applicable in case of new shareholders or investment from outside the group. A non-deductible loss will be preserved in the amount of the undisclosed reserves.

- **Securities lending:** Some companies lend securities to other corporations which do not have to pay any taxes on the capital yields. If these companies borrow securities from another company, the fee for these securities is a business expense which lowers the profit and therefore the tax burden. In the new system, these fees will not be tax-deductible (except the borrower does not receive any profits by holding these securities). The fee for the transfer of securities will be subject to a capital gains tax of 15 %. Some of these regulations have yet become effective in the fiscal year 2007.



Finance Minister Peer Steinbrück (Social Democratic Party) in the German parliament on 25 May 2007: "Against all prophecies the Grand Coalition has been quite successful by presenting the business tax reform."

- **Changes of the Foreign Relations Tax Act:** The aim of this law is to avoid a tax evasion by companies which use tax deductions under false pretences with companies abroad that belong to the same group, for example a company pays a fee for a licence to a firm in another country although both companies belong to the same group and the royalties are used as business expenses reducing the tax load. The law says that finance authorities will

base the taxation of business relations with foreign enterprises on the conditions which are used in business relations by independent firms. There is a new definition of the arm's length principle in the law.

- **Flat tax for income on capital:** With the beginning of the fiscal year 2009 most incomes of capital is subject to a flat tax of 25 % plus solidarity surcharge and church tax. Capital earnings paid before the end of 2008 will be taxed with the individual income tax rate. This new flat tax relates to all capital income such as dividends or interests on savings deposits earned by private citizens. The new regulations do not apply to capital gains earned in connection with professional capital ownership.

The bank keeping the capital for the private customer deducts the flat tax and transfers it to the finance authorities. Capital gains are not taxable if the entirety of such gains does not exceed the amount of 801 EUR or 1,602 EUR for married people in case they are taxed together. Expenses made for capital ownership will be non-deductible. As people with low income pay tax rates lower than 25 %, the tax payer may demand the taxation of capital incomes with the individual (lower) tax rate. If the tax burden assessed in this way is higher than the tax flat there is a legal fiction saying that this demand has not been requested. By this regulation, it is generally possible to prove the correctness of the deduction made by banks.

If the taxpayer is subject to the church tax the flat tax will be reduced by 25 % of the church tax levied on the capital gains. This will not be done automatically but if the taxpayer demands it. If he does not, the taxpayer has to mention the capital gains which are subject to the church tax in the tax declaration. Many critics blame that now bank customers have to tell their bank about the religious affiliation.

The new German flat tax also affects foreign capital gains earned by taxpayers in Germany who are entirely assessable to income tax. The foreign tax paid on these incomes has to be taken into account with the German flat tax. In case of double taxation treaties this regulation is only applicable if the treaty provides this. Until the coming into operation of the new flat tax dividends had been subject to the half-income system. This meant that only half of the capital gain was subject to taxation but the individual tax rate depending of the entire income of the taxpayer was used for taxation. In the old system, the tax withhold by banks on dividends was only a prepayment.

Corporations generally do not pay taxes on gains received by holding foreign shares (5 % of the pay-out may not be used as business expenditures).

The introduction of the flat tax has been accompanied by an expansion of the **speculation tax** which is a part of the income tax. In Germany, profits realised by the sale of shares or other securities within a year after the purchase had been subject to taxation if the profit was higher than 512 EUR. In the new law, there is no time-limitation which means that all profits earned by the sale of shares that have been purchased after 31 December 2008 or by time bargains are taxable. Losses made by the sale of stocks may only be compensated with gains made by the sale of stocks.



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- **Online-verification of bank accounts:** Due to the introduction of the flat tax for capital gains the applicability of the online-verification of bank accounts has declined. But the new law contains a general clause allowing the Federal Financial Authorities to proof online if a taxpayer possesses a bank account. Credit institutions have to allow these authorities to check online the existence of accounts in order to avoid defraudation in taxes. Neither the bank nor the account holder has to be informed.

For more details, please see my document on the business tax reform in German:
<http://www.janvonbroeckel.de/oekonomie/unternehmenssteuerreform.pdf>

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