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**Business-related  
German tax aspects**

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Chart I	Income tax rate 2006
Chart II	Social security Rates 2006
Chart III	Encumbrance of salaries with public charges

## **I. Major developments**

After a decade of permanent legislative reforms which generated yearly between one and four Tax Amendment Acts, Germany is waiting now for a substantial Tax Reform for business-oriented regulations. Even after the change of the Federal Government in September 2005, the eagerly awaited substantial reform failed to appear. It is postponed and announced to come into effect Jan. 1<sup>st</sup>, 2008. The main issue will be to converge the different tax regulations for corporations and sole proprietorship / entrepreneurial partnerships to a single tax system. Details are not reliable since two committees of experts did work on different systems. Now, the Administration of Finance works non-publicly on a unification of both systems.

Actually, the German Transformation Tax Act (Umwandlungsteuergesetz) is subject to a reform. The right to displace the seat of a corporation, as it is ruled for the Societas Europaea (SE) forces innovations. However, actually the intentions of the Ministry of Finance is even to reduce some rights to transfer hidden reserves and loss carry forwards.

Concerning intercompany pricing, the Ministry of Finance launched several decrees (BMF-Schreiben) in which severe demands of documentation for the domestic taxpayers are given. Coming tax field audits and the resultant lawsuits will show whether the requirements and consequences (penalties up to 1.000.000 Euro) are overdrawn. For the time being it is to state that it is nearly impossible to meet the requirements.

Under the labelling "rich-fellow-tax" (Reichensteuer) it is intended to implement an increase in the maximum income tax rate beginning at January 1<sup>st</sup>, 2007. The taxable income of individuals, exceeding the amount of 250.000 Euro p.a. (for married couples which elect a joint filing, the amount doubles) shall be taxed by a top rate of 45 % (instead of 42 %). It is still under discussion, whether income from trade or business will be exempted.

A fundamental decision of the Federal Constitution Court is expected concerning the Inheritance and Gift Tax Act within the next 12 months. Several constitutional complaints deal with the tax treatment of real estate and shares in family business. Therefore most likely there will be a substantial reform of the said tax act.

## **II. General items**

### **1. Liability to tax**

The German tax system is characterized by the dualism, that individuals and companies operating a business are subject to two different taxes on income. Taxes on capital as net worth tax or trade capital tax are no longer collected since several years.

All income is subject either to income tax (Einkommensteuer) or to corporate income tax (Körperschaftsteuer), which depends on the fact whether the income is earned by a company or by the individual itself. Besides that, business income is additionally subject to trade tax (Gewerbsteuer).

German resident individuals or companies are liable to income tax or corporate income tax on their world-wide income, where ever arising during their accounting period and to trade tax on their German business income.

German tax law does not distinguish expressly between “resident” and “non-resident” but between tax payers who are subjects to unlimited tax liability and those who are subject to limited tax liability.

An individual is considered to be resident in Germany if there is a permanent residence or a physical presence in Germany for more than six month in one calendar year or for at least six consecutive months over a year end.

A company is subject to unlimited tax liability if either its seat (Sitz) or its place of management (Ort der Geschäftsleitung) is located in Germany. Due to the legal requirement to define the seat in the articles of association, every German company is subject to unlimited tax liability.

Individuals with limited tax liability are subjects to income tax, depending on their type of income. German limited tax liability encompasses income from a trade or business for the purpose of which a permanent establishment in Germany is maintained. The same applies for a non-resident company acting in Germany through a branch. Besides that, income from a practice or profession, income from employment that is performed or the benefits of which arise in Germany, income from letting property situated in Germany and income from German shares securities are taxable in Germany.

## **2. Tax year**

The tax year is the calendar year. If the accounting period does not match with the calendar year, which is allowed to individuals and companies of any kind who carry on a trade or business, profits are allocated to the calendar year in which the accounting period ends. The approbation of the competent Inland Revenue Office is required to shift a concurrent accounting period to a displaced period (e. g. into an accounting year beginning April 1<sup>st</sup>).

In no case an accounting period may exceed a period of 12 months.

## **3. Rates of tax**

The corporate income tax is at a rate of 25 %. There are no different tax rates on retained or distributed earnings or on unlimited or limited tax liable companies. Insofar the actual German tax system is unlike to the tax rate system of the last decade.

The tax rate for individuals is laid on a taxable income above 7.664 Euro (for married couples the amount doubles). The tax rate increases from 15 % progressively to a maximum of 42 % (see chart I).

Married couples may elect to pay tax on their combined income (joint filing). In computing the tax liability, the tax table on half of a combined income is doubled, so-called "Splittingtarif".

The tax rate of solidarity surcharge (Solidaritätszuschlag) is 5.5 %.

The tax rate for individuals with limited tax liability is generally the same as for unlimited liable tax payers, however the minimum income tax rate is 25 %.

Regarding the trade tax rate -> VII. 3..

## **4. Tax declaration**

Income tax, corporate income tax and trade tax forms must be filed on completion of a tax year. The due-date is May 31<sup>st</sup> of the following calendar year. Customarily, the deadline is extended to February, 28<sup>th</sup> of the next but one year if the tax form is filed with the involvement of a tax advisor.

Income tax, corporate income tax and trade tax have to be paid within one month after notice assessment.

## **5. Tax payments**

Advanced payments of income tax, corporate income tax, trade tax and property tax are due in different quarterly instalments with the final amount payable within one month of a former notice assessment. Advanced payments are generally based on the previous year's tax assessment.

Depending on the amount of turn over in the current year and the previous year, VAT has to be paid monthly, quarterly or yearly.

Overdue payments are charged with an interest rate of 1 % per month. For the period between the emergence of tax (for income-based taxes this is normally the end of the calendar year) and the notice assessment, due taxes as well as overpaid taxes bear an interest of 0.5 % per month after a 15 month period of grace.

### **III. Computation of taxable income**

#### **1. General**

The method of computation of taxable income depends on the type of income. All income is calculated on the period-based-method.

The business income is based on the bookkeeping as it is provided for business enterprises by German Commercial Code (HGB). Incomes from other sources, in particular from land and lease and from capital investment, are calculated on a cash based accounting. In between are professional independent services. Accounting is not compulsory, but possible. However, the taxable income is calculated profit-oriented.

A distinguishing mark between the type of income which is taxed on a profit-oriented basis and those, in which the exceeding amount of receipts to expenses constitutes the taxable income, is the distinction between the accounting basis and cash basis. In the latter case income is determined as the residual of the receipts minus expenses.

#### **2. Commercial accounting**

Individuals as sole proprietorship, entrepreneurial partnerships and corporations are obliged to set up annual financial statements in line to the local GAAP. There are special tax provisions that describe bookkeeping requirements for the tax payers who are not subject to German Commercial Code, depending on the amount of turn over or profit.

#### **3. Depreciation and Depletion**

##### **a) Method**

Generally, the tax payer has the option to write off the purchase price or the cost of construction either in equal yearly amounts during their customary useful life (straight-line-method) or applying a fixed percentage of the book value (declining balance method). For certain kind of assets this right of option is restricted. According to a principal, the treatment for bookkeeping purposes must be adopted in the tax-balance-sheet. The depreciation method for tax purposes depends on the accounting method.

## **b) Buildings**

For buildings there are very various depreciation rates. They differentiate between

- the purposes (residential, non-residential)
- the belonging to the working capital or not
- the date of the construction permit or the conclusion of the sales contract.

### **i Straight-line-method**

- As an operating method
  - not used for residential purposes
  - date of apply of construction permit
    - earlier than end of 2000      4 % p.a.
    - later than end of 2000      3 % p.a.
- privately held or used for residential purposes
  - date of apply of construction permit
    - earlier than end of 1924      2,5 %
    - later than end of 1924      2,0 %

### **ii The declining-balance-method-rates are even more detailed. They vary, depending on the kind of building, its usage and age and on the fiscal year which is concerned between 10 % and 1,25 % p.a..**

## **c) Movable goods and business assets**

The declining balance method is subject to the restriction that the applicable rate may not exceed two times the rate of the straight-line-depreciation, and in no case may it exceed 20 %. As a third method, depreciation may also be based on the economic performance of the asset.

If the purchase price/cost of production of the asset does not exceed the amount of 410 Euro (plus VAT), an entire depreciation in the year of purchase/production is permitted.

## **d) Immovable assets/intangible assets**

Those assets may be depreciated only by the straight-line-method.

**e) Goodwill**

A capitalized goodwill has to be straight-line-depreciated for tax purposes during the period of 15 years (commercial balance sheet: 4 years). The period can be shortened in case of a certain personal based goodwill as it may occur in particular with independent services, e. g. doctor's or consultant's offices.

**f) Loss of value**

Special depreciation may be taken to reflect the permanent diminution in value by an accelerated depreciation where the useful life is shortened by shift work, for example.

**g) Depreciation Lists ("AfA-Tabellen")**

The tax authorities publish regularly tables giving the economic useful life and depreciation for ware and tare for a wide range of goods. Deviation from these rates by the tax payer is permissible, if it can be justified.

**4. Stock / Inventory**

Stocks and work in progress are valued at the acquisition or manufacturing costs (movable goods on a weighted average cost basis) or at going concern value, whichever is lower. Unlike first-in-first-out (FIFO) which is not applicable for tax purposes, the last-in-first-out-method (LIFO) is available, if also used in the trade balance sheet.

**5. Taxable business profit**

The starting point to calculate taxable income for commercial or industrial activities, professional independent services and agriculture and forestry is the profit, computed as described above.

On the basis of a statutory account some specific adjustments for tax purposes have to be made by determining of taxable profits. The main items are

a) Deductions

- Capital contributions
- Profits from a foreign branch are tax exempt under tax treaty
- Dividends from a foreign subsidiary are tax exempt under tax treaty

b) Additions

- hidden profit distributions
- 50 % of the remuneration of the members of the advisory board
- gifts
- entertainment expenses. Only 80 % of the relevant business entertainment can be deducted for tax purposes
- income tax or corporate income tax and VAT on non deductible expenses
- Business expenses relating to non-taxable income or gains, if no exemption is applicable.

Most important adjustments concern the divergent valuation of accruals in the accounting and for tax purposes, in particular liabilities which are only to be fulfilled by future earnings or profits, for anticipated or contingent losses or for non-interest bearing long-term liabilities.

## **6. Transaction between related parties**

Revenue transactions between related parties, in particular cross-border transactions, have to be at arm's length. Besides that, it is prerequisite, that

- any business relationship between related parties has to base on a written contract.
- This contract has to be closed in advance. This condition even applies if an upfront written contract should not be habitual in the concrete business area (e. g. automobile trade).
- Related parties execute the contract accurately.

Otherwise for tax purposes any payments to the related party are considered as hidden distribution or (hidden) capital contribution instead of a business expense.

#### **IV. Income tax items**

##### **1. Capital gains**

###### **a) General**

Not regarding the fact that Germany did not implement a specific capital gains tax, it is subject to tax in the following cases

- i The disposed assets are employed in the business of a sole proprietorship or an entrepreneurial partnership or a corporation. In the latter case the gains are subject to corporate income tax. In the two other cases they are deemed as ordinary business income.
- ii In case of turn-over of a privately held asset, the capital gain is considered to be a speculative gain. Subject to taxation of speculative gains is
  - the sale of real estate or similar rights (inheritable building rights) if the real estate is sold within a period of ten years after acquisition,
  - the sale of movable assets, in particular securities, if the sell takes place within a period of one year after acquisition,
  - in cases, in which the sale takes place earlier than the acquisition of the respective asset.

It has to be highlighted that losses deriving from speculative sale transactions as described above can only be credited against speculative gains. They can not be set off against profits deriving from other types of income. However, such losses can be carried back or carried forward in other tax periods.

- iii Outside the speculative term (see above ii) capital gains resulting from the sale of privately held shares in a corporation are taxable, if the seller participates in the share capital of a corporation with at least 1 %. This is considered to be business income without being subject to trade tax. For the taxation, the specific partially tax exemption (only 50 % of the capital gain is taxable – Halbeinkünfteverfahren, s. item b)) applies.

## **b) Capital gains from shares in corporations**

As a consequence of the abolition of the so called “imputation corporation tax system” (Anrechnungsverfahren), dividends distributed by a corporation or capital gains on shares of a corporation are subject to a largely tax privilege (Halbeinkünfteverfahren).

- i Dividends of a corporation, no matter if it is German or non-German, are taxed only by 50 % of the dividend if the shareholder is an individual or a partnership.

Correspondingly, only 50 % of the related expenses are tax deductible.

- ii Also, for capital gains on shares in a German or Non-German Corporation a 50 % tax exemption applies. Technically German tax law provides, that only half of the proceeds of the transfer of shares are considered and, correspondingly, only half of the acquisition cost/book value and half of the purchase costs can be deducted.

Consequently, only 50 % of a write-off and of expenses related to the participation are tax deductible.

For corporations as beneficiaries (directly or as a partner in a shareholding partnership), specific regulations apply (-> V. 1., V. 2.).

## **2. Loss carryover**

### **a) General**

Loss carryovers are subject to several restrictions. First of all there are some limitations to transfer losses coming out of some specific types of income to other income sources. The most important restrictions concern the losses from a shareholding as limited partner in a limited partnership (-> IV. 3. e)) and losses suffered from speculative transactions (see above).

Secondly there are some restrictions concerning the maximum amount up to which the loss can be used in a fiscal year (-> b), c)).

### **b) Loss carry back**

In principal there will be a loss carry back to the previous fiscal year up to an amount of 511.500,00 Euro (all figures mentioned in this chapter are doubled for married couples which elect a joint filing). The exceeding amount of a loss can be carried forward to future tax years.

On request of the tax payer, the loss will not be carried back totally or partly but be carried forward entirely.

### **c) Loss carry forward**

Also, the usage of losses carried forward is limited. They can be credited against the future profits only up to an amount of 1 Mio. Euro p.a..

If the profit exceeds this amount, existing loss carry forward can only be credited with a rate of 60 % against this profit. 40 % of this exceeding profit will be taxed by the normal tax rates. The remaining amount of loss carry forward can be used under the same restrictions in the following tax periods.

Thus, Germany has a system of loss-carry-over-limitation, in which profits exceeding the amount of 1 Mio. Euro will be taxed on a quota of 40 % in any case, that means not regarding the amount of any existing and assessed lost carry forward (Mindestbesteuerung).

## **3. Partnership**

### **a) General**

The tax treatment of a partnership depends on its activity. Since for income tax purposes, the partnership is under the regime of transparency, in case of business activities the partnership is deemed to be a permanent establishment of the partners. So if general conditions of a permanent establishment (which are relatively identical to the catalogue of article 3 of the OECD-Model-Convention) are met, the business income of the partnership is subject to income tax or corporate income tax on the level of the partners; the entrepreneurial partnership itself is subject to trade tax.

If the partnership does not act entrepreneurially, but in the business area of Rent and Lease, it is not obliged to keep bookkeeping.

**b) Legal form/tax treatment**

The *terminus technicus* „Partnership“ used on a tax background does not match exactly with a specific legal form of German commercial or corporate law. From the legal point of view, there are several activities which may be called “partnership”

- Gesellschaft bürgerlichen Rechts („GbR“ or „BGB –Gesellschaft“ = Civil law Partnership) , §§ 705 et. sequ. Bürgerliches Gesetzbuch - BGB
- Stille Gesellschaft, (silent partnership), §§ 230 et. sequ. Handelsgesetzbuch - HGB
- Offene Handelsgesellschaft („oHG“ = ordinary partnership), §§ 105 et. sequ. HGB
- Kommanditgesellschaft („KG“ = limited partnership), § 161 et sequ. HGB
- GmbH & Co. KG, which is not a separate legal form, but a variation of a KG, in which the sole general partner as fully liable partner is a GmbH.

The three latter partnerships are entrepreneurial partnerships by law.

**c) Tax liability**

For taxation purposes, the partnership is treated differently. Whilst it is taxpayer for trade tax and VAT purposes, for the income taxation the partnership is transparent. Therefore, profit and loss is not taxed at partnership's level but attributed directly to the partner and taxed at his level. Unlike with corporations, the attribution does not require a shareholders resolution, the distribution effects automatically. Besides that, the transparency has some impact on the calculation of taxable income (-> d).

**d) Taxable income adjustments**

The calculation of the amount which is allocated to the partners as their taxable income is based principally on the general accounting and tax calculation principles. Nonetheless, some additions are made as far as specific business relations between the partnership and a partner are concerned. As a consequence

- the remunerations for rendering services to the partnership
- rent, royalties of the partnership, paid to a partner

are not deductible. Those payments are treated as an advanced profit share of the said partner.

**e) Loss deduction**

For limited partners of a limited partnership ("Kommanditisten") the attributed loss is subject to an at-risk limitation. The limitation is defined by the amount of his contribution. An exceeding amount of attributed losses has to be carried forward to be set off against profit shares of the said partner in the same partnership in future years.

Not regarding that the partnership itself is subject to trade tax, the system of transparency causes some restrictions in view of the usability of a trade tax loss carry forward in case of a change of the partners. (-> VII. 5.).

## **V. Corporate income tax items**

### **1. Capital gains**

For corporations with unlimited tax liability there are no specific provisions for the taxation of capital gains. Profits from the sale of goods and services of all kinds are generally taxed as ordinary income on the normal tax rate, with exception of capital gains deriving from the sale of shares in corporation. (-> 2. b))

For corporations with limited tax liability the German tax system distinguishes between profits derived from the disposal or movable of immovable assets, functional units and rights, which are dedicated to the domestic branch. In this case there is no distinction between ordinary income and capital gains as it is applicable for unlimited tax liable corporations.

If the disposal does not concern any business assets of the branch but those which are dedicated to the parent house abroad, the same regulations as for capital gains of limited liable individuals apply (-> IV. 1.).

### **2. Tax free income**

#### **a) Intercompany dividends**

The revenues of a corporation from

- dividends of another corporation
- liquidation of a corporation
- a decrease of a registered share capital of a corporation

are tax exempt.

The tax exemption applies no matter if the distributing corporation or the receiving corporation is resident in Germany or not.

Expenses, which are related directly or indirectly (economically) to the tax exempt dividends are entirely deductible. However, there is a fiction by law that 5 % of the dividends (!) are deemed to be non-deductible business expenses. Thus, in case the business expenses are nil, only 95 % of the dividend is tax exempt, 5 % is taxable income. On the other hand, if there are wholly-deductible business expenses (e. g. cost of financing) and they exceed the amount of 5 % of the dividends, they will be credited entirely on the 5 % amount.

## **b) Capital gains from shares in corporation**

Capital gains from shares in corporation and profits and a liquidation profits are tax exempt.

As for the tax exemption of dividends (-> V. 2. a)) the regulation applies also for non-German corporations, as far as they are subject to limited taxation.

On the other hand, losses are non-deductible for tax purposes, as far as they result from a revaluation of the participation in the distributing corporation in the balance sheet of the shareholding corporation or from the liquidation of the company.

As for the tax exemption of dividends (-> V 2. a)) related expenses are fully deductible. However, 5 % of the dividend is deemed to be a non-deductible expense.

The tax exemption of capital gains from shares is subject to several anti-abuse clauses and re-exemptions.

## **3. Loss carryover**

For corporate income tax purposes the loss carry back restrictions are similar to the regulation of the income tax.

The loss carry forward requires a legal and economic identity of the corporation. "Legal identity" means, that not more than 50 % of the shares in the corporation have been transferred in the meantime of the tax period, in which the loss is suffered and the tax period, in which the loss should be credited against profits. The second condition is, that not more than 50 % of the net assets with which the corporation runs its business has been contributed into the company within a five-year-period. Practically this "economic identity" may cause serious problems.

On the background of this general requirements, loss carry forward is possible under the same limitations as described for the income tax (-> IV. 2).

#### **4. Fiscal unity**

The fiscal unity applies for corporate income tax as well as for trade tax purposes under the same conditions.

Unlike the tax system of other European countries, German tax law does not consider a group relief. However, under the following conditions it is possible to build up a fiscal unity according to which any profit or loss of a subsidiary is automatically attributed to the parent company. Thus, profit or loss of the subsidiary is directly credited with the parent companies' originally income, or other income which is attributed to the parent company from other subsidiaries by their fiscal unity.

Qualified as a parent company are

- unlimited income tax liable individuals,
- a partnership, as it is acting in own business activities,
- and a corporation having its place of management in Germany.

A parent company must have a majority (directly or indirectly) of the votes in the subsidiary for its entire fiscal year. Therefore, it is not possible to build up a fiscal unity during the tax period of the subsidiary unless the parent company was majority shareholder already at the beginning of subsidiary's fiscal year.

A profit and loss transfer agreement has to be closed between the parent company and the subsidiary. It is prerequisite, that this agreement is registered at the commercial register of the subsidiary by the end of the first respective fiscal year of the subsidiary, for which the fiscal unity shall apply.

#### **5. Thin capitalization**

On the background of the general dealing at arms'-length principle, interest payments on shareholders' loans are generally deductible with the reservation, that the thin capitalization restrictions are not infringed.

As a consequence of the thin capitalization rules, interest payments to the shareholders or a related party of the shareholder are requalified in hidden profit distributions, then interest payments are not tax deductible.

The thin capitalization regime requires:

- The Borrower is
  - a corporation or
  - a partnership in which a corporation is partner with a share quota of at least 25 %.
- The lender participates in the share capital of the corporation with at least 25 %. The participation can be held directly or indirectly via a partnership.
- The consideration is
  - pure interest (based on a fixed percentage of a principal amount) and the shareholders loan exceeds at any time within the fiscal year an amount of 1.5 times the proportional equity; it is a serious handicap, that for the thin capitalization purposes the book value of participation in corporations is deducted from the amount of net equity.

This condition is not fulfilled if it can be proven, that an unrelated third party (especially: bank) would grant a loan under the same conditions and circumstances.

- The consideration is not based on a fixed percentage of the principal amount.
- The consideration for the shareholders loan exceeds an amount of 250.000,00 Euro p.a..

Besides that, several anti-abusing clauses apply. Especially a third party lending a loan to a corporation is considered to be a shareholder, if the third party has recourse against the shareholder.

For a holding company as a lending party some relieves apply, especially the deduction of the book value of participations is not applicable.

## **VI. Solidarity surcharge (Solidaritätszuschlag)**

A solidarity surcharge of 5.5 % of the assessed income tax or corporate income tax is collected.

It is assessed automatically by the fiscal authorities with the said taxes. Because it is a surtax to income tax or corporate income tax, the general descriptions of tax liability apply.

A tax declaration for solidarity surcharge purposes is not required.

## **VII. Trade tax items**

### **1. Subjects to tax**

Subjects to trade tax are

- individuals and partnerships, which are unlimited tax liable and doing business,
- individuals and partnerships, which are limited tax liable doing business in Germany through a branch or a permanent establishment with its domestic profits,
- unlimited tax liable corporations,
- limited tax liable cooperations doing business in Germany through a branch or a permanent establishment with its domestic profits.

### **2. Taxable income**

Trade tax is laid on the base of business income. It is calculated basically on the business profit for income tax or corporate income tax purposes with some adjustments.

Some additions have to be made for certain costs which have been deducted from the taxable income for income tax or corporate income tax purposes.

The most important additions are

- 50 % of interests or other kind of consideration on long term debts,
- 50 % of the rental expense of movable property, if the rental income is not subject to trade tax thereon,
- profits from partnership interests,
- amount of the write-down of the book value of a participation in a corporation to a going concern value, if it is caused by relevant dividend payments.

Major deduction items are

- 1.2 % of the unit value (Einheitswert) of real estate,
- profits arising pro-rata from a entrepreneurial partnership,
- dividends from active non-resident companies, in which a substantial share quota of at least 10 % is held,
- profit arising from partnership interests,
- profit arising from a permanent establishment not located in Germany.

### **3. Tax rate**

For corporations, the basic trade tax rate is 5 %, multiplied by municipal trade tax multiplier (Hebesatz). The multiplier is to be determined by each municipality and is on average rate about 420 %. There is a minimum multiplier of 200 % by legal requirement.

For partnerships/individuals doing business, there is a tax free amount of 24.500 Euro. The basic tax rate depends on the trade income and ranges from 1 to 5 %. The multiplier of 5 % is applicable on taxable business income above 48.000 Euro.

Calculating the trade tax, please keep in mind that trade tax is treated as a deductible expense.

### **4. Trade tax credits**

For partners of a partnership and individuals doing business, the trade tax will be credited to the income tax. Corporations are not entitled to participate in this benefit. Due to a certain limitation stated in the calculation formula of the tax credit procedure, the trade tax credit procedure may release tax payers only in a small number of cases entirely from their tax burden. Normally, however, it comes to a substantial release of roundabout 75 %/80 % of the trade tax liability.

## **5. Loss carryover**

Unlike income tax and corporate income tax, the trade tax does not make arrangements for the loss carry back.

Loss carry forward requires the legal and economic identity of the tax payer. The conditions to meet are different for corporations and partnerships/sole proprietorships.

- i For corporations the economic identity is kept, if not more than 50 % of the shares in the corporations have been transferred within a five-year-period. Second condition to meet is that the business is not operated with mainly new assets having been contributed into the companies within a five-year-period.
- ii With regard to partnerships or sole proprietorships, the identity has to be kept as well for the business as for the entrepreneur.

The requirement of the identity of the business is met if the business area, the customers and the employees remain more or less the same. The identity of the entrepreneur requires no change in the partnership. Otherwise, the come out of loss carry forward is refused pro rata for the share of a withdrawn partner.

Losses can be deducted immediately only up to an amount of 1 Mio. Euro. An exceeding loss can only be used up to 60 % of the profit. The remaining loss has to be carried forward for future tax periods.

## **6. Fiscal unity**

For the conditions and consequences of a fiscal unity -> V. 4.

## **IIX. Withholding Tax**

The most important withholding taxes and tax rates are:

- wage tax on wage / salary paid to an employee at the progressive income tax rate of the employee
- considerations for non-resident members of a supervisory board of a corporation at a tax rate of 30%
- dividends at a tax rate of 20%
- profit sharing interest ("partiarisches Darlehen") at a tax rate of 20 %
- profit share of a silent partnership ("stille Gesellschaft") at a tax rate of 20 %
- interests at a rate of 30 %
- royalties, if paid to non-residents, at a tax rate of 25 % (payments to a EU-creditor may be exempt from withholding tax according to the EU-savings directive).

Withholding tax on dividends and interests often is reduced by double tax treaties or EU-parent-subsiidiary directive. However, the German debtor generally is obliged to withhold the tax at the normal withholding tax rate. The non-German creditor must claim refunds of excess tax withheld from the German Federal Finance Authority (Bundeszentralamt für Steuern, former: Bundesamt für Finanzen). On application, the Bundeszentralamt issues a notice of exemption so that the withholding could be effected at the reduced rate.

Withhold tax has to be paid by the tenth of the following month.

## **IX. Value added tax**

### **1. Taxable transactions**

Value added tax is charged on the supply of goods and services in Germany by business entities (including foreign entities). VAT is levied at all levels of production, distribution and services.

Not regarding, whether the tax has to be borne by the final customer, on every level the entrepreneur is tax payer. The tax rate is charged to the rate of 16 % (2007: 19 %). Certain supplies of goods and services are exempted from tax or zero rated. The latter category includes the export of goods and certain services from Germany. A lower tax rate of 7 % is levied on certain agricultural forestry products, food, graphical products and artificial body parts.

### **2. Fiscal unity**

The VAT System also is familiar to the fiscal unity. The tax unity requires financial, economic and organisational integration of the entrepreneur into the business of another entity. Unlike the fiscal unity for corporate income tax purposes, under the VAT system the group as a whole is regarded as an entrepreneur and liable for the VAT. As a consequence of the fiscal unity, productions, distributions or services between the members of the fiscal unity are not taxable.

Different from the corporate income tax, the fiscal unity for VAT purposes is not a vehicle for saving taxes, it only simplifies the taxation. Another opinion has to be given in case the group does not supply products or services to third parties, which are subject to VAT itself.

### **3. Reverse charge procedure**

Under certain circumstances not the entrepreneur or supplier, but the recipient of supply of goods and services is liable to VAT payments to the tax authorities. Correspondingly, the VAT paid by the entrepreneur for the receipt of goods or services can be credited against the VAT due on taxable events at this level.

#### **4. Tax credit (Vorsteuer)**

If the entrepreneur carries out a taxable supply of goods or services, he can set off the paid VAT for taxable supplies of goods and services he received for his business. If the prepaid VAT exceeds the due VAT of the entrepreneur, the excess amount is to be refunded by the tax office.

On the background of tax abuse, there are numerous formal requirements for the input VAT credit.

## **X. Real estate acquisition tax**

The transfer of domestic real estate such as land buildings, heritable building rights or condominium is subject to real estate acquisition tax. Tax base is the purchase price, the exchange value, the value of any consideration or the value of the contribution latter particularly in cases of an issue of shares.

Tax rate is 3.5 %.

The tax is generally imposed on

- any obligation to transfer, sale or exchange and a transfer of beneficial ownership in real estate
- on the transfer of at least 95 % of interest in a domestic or foreign corporation or partnership owning real estate in Germany.

Besides that, some types of company transformation (merger), change of form or transfer of assets may also trigger real estate acquisition tax.

Several tax exemptions apply for the transfer for real estate between spouses, parents and children or partners and partnership.

## **XI. Inheritance and gift tax**

As a rule, both kind of transactions are treated alike. The applicable tax rates vary from 3 % to 70 % and are determined (increasingly) by the value of the relevant goods as well as (decreasingly) by kinship between beneficiary and donor.

A number of transferable assets are just taxed on the basis of a fraction of their market or book value. Additionally, there are tax free amounts, depending on the personal relationship (spouses, parents and children) between the involved parties.

Valuations of certain goods are subject to sophisticated rules. E. g. the valuation of real estate and some kind of partnership and business operations are assessed with amounts which are in general lower than the market value. This privileged tax treatments are subject to constitutional complaints. It is indicated, that the German Federal Constitution Court (Bundesverfassungsgericht) ponders whether there is a violation of the principle of equal treatment for tax purposes. Therefore it is an uncertainty in which way the expected amendment of the inheritance and gift tax act will transform and restructure the tax treatment.

## **XII. Real estate tax (Property tax)**

Generally, all real estates are subject to an annual real estate tax. Tax liable is the owner of the property.

Tax base is the assessed value of the property which may be substantially lower than the fair market value. As with trade tax, the tax rate is calculated on a basic rate and a municipal multiplier. The practically most relevant basic rate is 0.35 %. The municipal multiplier ranges from 190 % up to 660 %.

Real estate tax is a deductible item for income tax, trade tax and corporate income tax purposes.

### **XIII. Taxes on payrolls (social security)**

In Germany social security is not financed by taxes. It is a comprehensive insurance system that includes four types of insurance

- old age or long-term disability
- unemployment insurance
- health insurance
- insurance for nursing care.

Membership is obligatory up to a wage/salary level of 47.250 Euro per year in 2006.

The basis of assessment for insurance contribution is the gross income of the insured employee up to 63.000 Euro p.a., in "Neue Bundesländer" (area of former GDR) the cap is lowered to 52.800 Euro and for the purposes of health insurance up to the above mentioned amount of 42.750 Euro. Any income exceeding this limit is irrelevant for purposes of the assessment. These limits are adjusted on yearly basis.

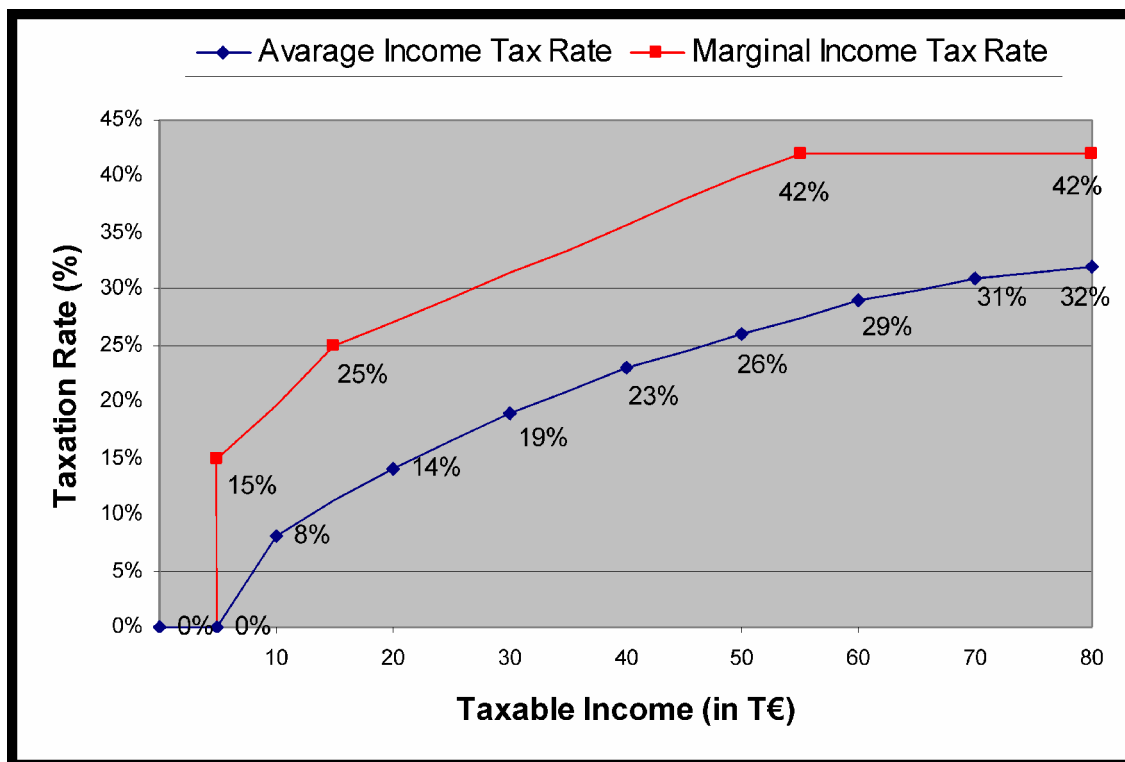
Both, the employee and the employer pay equal amounts of contribution. (Only for health insurance, there is a portion of 0,9 % which is borne by the employee exclusively.) The employer withholds the employee's portion from his or her compensation.

The actually rates are

- Old age and long term disability 19.5 %,
- Health 15.3 % (approximately),
- Unemployment 6.5 %,
- Nursing care 1.7 % (with an augmentation of 0.25 % for childless persons).

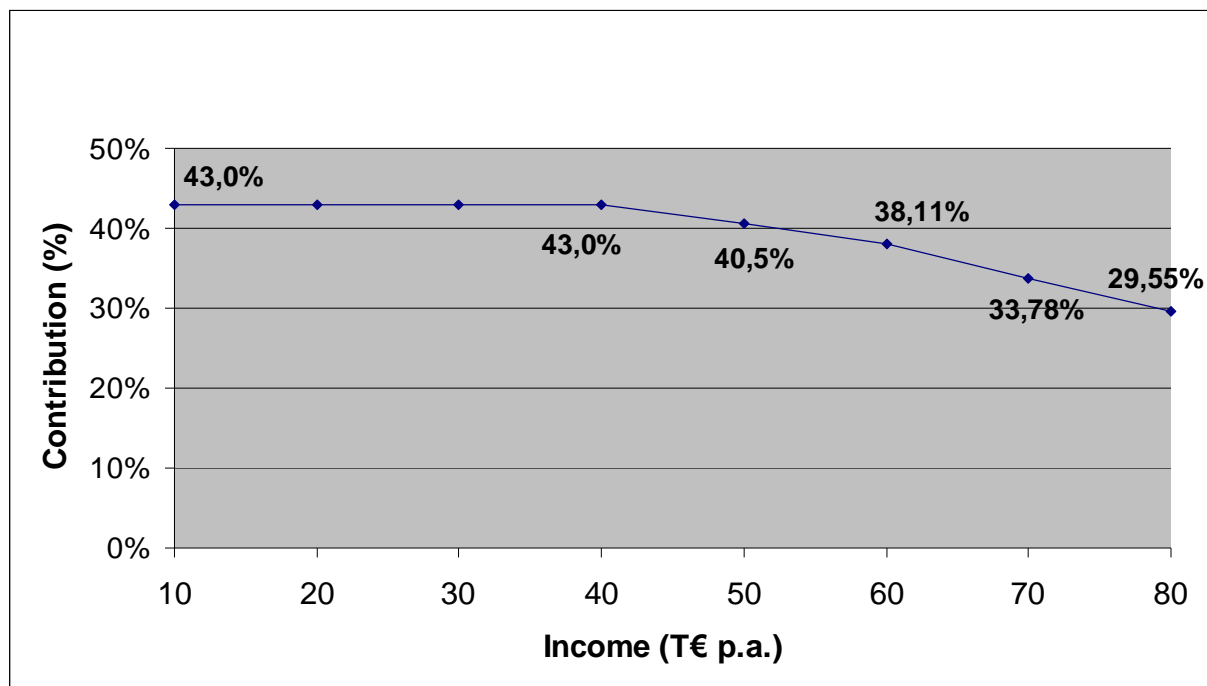
Please see Chart III for Encumbrance of salaries with public charges.

All employers are obliged to insure their employees against industrial accident or illness. These contributions are borne solely by the employers.

**Income Tax Rate 2006**

Zone	Taxable Income in T€*	Marginal Income Tax Rate (%)
O-zone	0 - € 7.664	0%
1. progression zone	€ 7.664 - € 12.739	15% - 25%
2. progression zone	€ 12.740 - € 52.151	25% - 42%
proportional zone	from € 52.152	42%

\* the amounts must be doubled in the case of a married couple which opts for joint filing

**Social Security Contributions 2006**

Pension Fund		19,5%	up to	€ 63.000 p.a.
Unemployment Insurance		6,5%	up to	€ 63.000 p.a.
Nursing Care Insurance		1,7%	up to	€ 42.756 p.a.
Health Insurance	approx.	<u>15,3%</u>	up to	€ 42.756 p.a.
		<u><u>43,0%</u></u>		

Chart III

Encumbrance of salaries with public charges 2006