

German Tax System



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Taxes are sometimes seen as an obstacle. We believe once you get acquainted with the tax system it looks only half that complicated. So see yourself about the German tax system:

Taxing Authorities

Taxes are levied by the federal, state and local governments. The most important taxes are federal taxes, regulated in the Income Tax Act, the Corporation Tax Act, the Trade Tax Act, the Value Added Tax Act, and the Estate and Gift Tax Act, as amended. The German Ministry of Finance issues interpretative regulations as well as letter-decrees in certain cases regarding the above-mentioned taxes and administers the federal laws through local tax offices (*Finanzämter*). An important source of statutory interpretation in tax matters is the decisions of the various Finance Courts (*Finanzgerichte*) and the Federal Finance Court in Munich (*Bundesfinanzhof*).

Principal Taxes

Taxes on income and gains

- Corporation tax
- Individual income tax
- Trade tax on income
- The solidarity surcharge on corporate and individual income tax

Taxes on transactions

- Value added tax

Important excise duties

- Mineral oil tax
- Tobacco tax
- State taxes on certain beverages

Taxes on transfer of property

- Gift and inheritance tax
- Real estate transfer tax

Taxes on property

- Real estate tax

Social Security

- Pension insurance
- Unemployment insurance
- Health insurance
- Nursing insurance
- Worker's compensation insurance

General

Each tax has its own personal and factual scope. One business transaction can give rise to several different tax liabilities.

Partnerships with business income are subject to trade tax on income and value added tax. The individual partners are subject to income tax on the income derived from the partnership. A corporate partner of a partnership is, however, subject to corporation tax on its share of the partnership profits.

Corporations are subject to corporation tax, trade tax on income and value added tax.

Lübeck has traditionally been a place for companies from northern Europe entering the German market. No wonder they find the dedicated support they need - in Lübeck.



A solidarity surcharge is levied on individual/corporate income tax payments.

Income tax structure

Under the German system resident individuals are subject to unlimited income tax on the net income derived from the following seven sources:

- Agriculture and forestry;
- Trade and business;
- Independent personal services;
- Employment;
- Capital investment;
- Rents and royalties;
- Other revenues.

The net income of each of the seven income sources is calculated separately (income after deduction of expenses) and then added together. From this total special tax allowances are deducted to arrive at the taxable income. Profits that do not fall within the seven income sources are tax free (e.g. lottery winnings, sale of privately owned capital assets except for the capital gains derived from transactions realised within a defined time frame). Income tax rates vary from a minimum tax rate of 16 % for income exceeding EUR7,664 to 45 % for income above EUR 52,152 for single individuals (EUR 15,328 /EUR 104,304 for married couples).

In addition, a 5.5 % solidarity surcharge on income tax is levied.

Owners of a business or individual partners of a business partnership are subject to a special business tax relief whereby an income tax credit reflecting the trade tax borne is granted if certain conditions are met.

Corporation tax structure and shareholder taxation

The taxable profit of a company is subject to corporation tax and trade tax on income. The corporate tax rate is 25 % without regard to distribution or retention. The same rate is levied on the profits earned by all foreign companies through their German subsidiaries or branches.

Corporation tax is also subject to a 5.5 % solidarity surcharge on tax. Trade tax is commented on below.

Due to the former imputation system for companies that have been subject to corporation tax the change of the tax regime at the end of 2000 might have resulted in corporation tax reserves that could be released from 2001 onwards over a period of 18 years. But according to modifications in the Corporation Tax Act any tax credit resulting from the former system is not available before the beginning of the year 2006.

Dividends distributed to domestic corporate shareholders are tax exempt. However, 5 % of the dividend amount is deemed to be a non-deductible expense, triggering income taxes.

To avoid double taxation in the hands of the domestic individual shareholder only 50 % of the dividends received are subject to personal income tax at the moment of distribution (half-income method). Since 50 % of the company profits distributed are subject to income tax only 50 % of all related expenses and losses can be deducted from the taxable income. Given that the „half-income method“ only applies in the case of a profit distribution the retention of profits is therefore „privileged“ with a relatively low tax rate of 25 % (plus solidarity surcharge) compared to a profit distribution.

Trade tax

The trade tax on income (*Gewerbeertragsteuer*) is based on the federal Trade Tax Act, but is levied by local authorities. Every local authority is allowed to determine its own trade tax rate for its area. The trade tax burden on income usually ranges between 9 % and 20 % of the business income. Trade tax is deductible as an expense against taxable income within the year of assessment.

A few local authorities have decided to abstain from their right to determine a tax rate or charge a lower rate considerably less than the average rate. Therefore, the legislator has introduced in 2004 a minimum tax rate of around 9 %.

Withholding taxes

Income from employment is subject to wage tax and solidarity surcharge on tax, which is withheld by the employer and remitted to the tax authorities. The amount withheld is credited against the personal income tax liability of the individual.

Since 2004 a new law has been enacted that obliges German subsidiaries of foreign companies to withhold wage tax for personnel who are under transfer from the parent. This regulation applies for subsidiaries that are not the legal employers of the personnel but that will effectively bear the cost of the employees. It is not necessary that the subsidiary directly pay the employee's salary for the rules to apply. Therefore, the subsidiary has to determine and to withhold the wage tax.

In addition, dividends and income from securities are subject to withholding tax of 20 %. Income from a silent partnership or from a profit participation loan are subject to a withholding tax of 25 %. Taxpayers subject to unlimited tax liability receive an equal tax credit that can be deducted from their total tax liability. Generally, withholding tax of 30 % on interest income is levied on persons subject to unlimited tax liability in Germany. Non-residents are exempted from this interest withholding tax.

Double taxation treaties that Germany has entered into often limit the withholding

taxes on dividends and also on royalties. A German taxpayer paying dividends or royalties generally has to withhold the tax at the higher, statutory rate; non-residents can claim either for a tax exemption certificate or for a refund of the tax withheld in excess of the withholding tax applicable under the relevant double taxation treaty from the German Federal Tax Agency (Bundesamt für Finanzen) in Berlin. According to the EU Parent-Subsidiary Directive no withholding taxes may be retained under certain conditions. Under the Interest and Royalties Directive, interest and royalties paid to associated EU companies are not subject to German withholding tax, if any. The German tax authorities have applied the Directive from 2004, although the Interest and Royalties Directive has not yet been implemented into German law.

Certain main contractors for domestic construction projects must withhold taxes in an amount equal to 15 % of the total consideration on account of the company performing the construction, unless an exemption was granted by the competent tax and revenue office.

Future developments

Beginning in 2005 the maximum individual income tax rate will be reduced to 42 %; the minimum income tax rate will be lowered to 15 %.

Regardless of these agreed changes, German tax law is still in a constant state

of development. The general aim is to reduce the overall tax burden at the cost of reduced tax exemptions and reliefs. Furthermore, a radical reform of the social security system is required to secure its future funding.

Even if the latest tax reform has just passed the German parliament and became effective as of 1 January 2004, it is considered to be not sufficient to manage the future challenges. However, future development will mainly depend on the majorities in the German Federal Parliament after the elections taking place in autumn 2006.

Administration

Tax legislation in Germany is normally proposed by the political parties represented in parliament and then enacted by the Federal Parliament. The revenue from the main German taxes is split between the Federal Government and the states. The majority of German tax revenue is derived from federal taxes.

The taxes are administered and collected by the Federal Ministry of Finance, the Ministries of Finance of the states and by various local tax offices (Finanzämter) throughout Germany. Every taxpayer is registered at a tax office responsible for the district of the company's or individual's residence.

Corporate taxpayers Compliance

The German tax system is not based on self-assessment (with the exception of VAT). The management of a company is instead obliged to file a tax return reporting the company's taxable income. If the return is not filed by the due date (including extensions), the tax authorities may assess the tax on an estimated amount and impose a penalty of up to 10 % of the amount due not exceeding a maximum amount of EUR 25,000. Since taxes are based on information in the return as given by the taxpayer, there are sanctions to prevent incomplete or inaccurate returns.

Tax returns

The corporation tax, trade tax and value added tax returns are due on 31 May following the end of the calendar (fiscal) year. A general extension until the end of September following the end of the calendar year is granted if a certified tax adviser, certified public accountant or a lawyer represents the taxpayer. A company can obtain a further extension until the end of February of the following year on special application by the above mentioned tax professionals.

When filing the returns the company must enclose the balance sheet and the profit and loss statement, including the notes to the financial statements and reconcile

the taxable income in the tax return with the income in the financial statements.

Payment and collection

Corporation tax and trade tax chargeable in a tax assessment are due one month after the taxpayer has received the notice of assessment.

The tax authorities fix quarterly advance payments based on the preceding assessment for corporation tax and trade tax. The prepayments have to be made

- for corporation tax on:
10 March; 10 June; 10 September;
10 December;
- for trade tax on:
15 February; 15 May; 15 August; 15
November.

If a taxpayer recognises during the year that the income will be lower than in the previous year a reduction of advance payments can be applied for.

If the tax finally assessed exceeds the amount of prepaid taxes, an interest charge of 0.5 % per month is levied on payments made later than 15 months after the end of the respective year. If taxes have been overpaid, the same conditions will hold for interest on refunds.

Any payment due according to the annual VAT return has to be paid within one month of its submission to the tax office.

The monthly or quarterly value added tax return leads to prepayments on the 10th day of the month following the end of the reporting period. It is possible to apply for a permanent extension of one further month if a special prepayment of 1/11 of the VAT due for the preceding year is paid in advance.

Employers must also remit income tax (wage tax) withheld from their employees, as well as social security contributions withheld from salaries and wages monthly and must also pay the employer's share of social security contributions. Wage tax returns have to be filed on a monthly or quarterly basis (depending on the tax volume).

If taxes are not paid or are paid late, the tax authorities assess a penalty of 1 % of the amount due for each month of delay. If the delay does not exceed three days, no penalties are assessed. This extension is not applicable for VAT and wage tax payments.

Tax audits

The tax authorities examine the tax returns submitted and make any inquiries they wish before finalising the assessment. Large companies are subject to tax audits at intervals of about four years. On demand, the taxpayer has to grant the tax auditor access to his EDP system for verifying the accounting records.

After such tax audits the tax authority may raise additional tax assessments if it disagrees with the taxpayer's treatment at the time of the initial tax return. The statute of limitations for the assessment of additional tax normally runs four years after the end of the calendar year. An extension of the statute of limitations for the assessment can arise if a tax audit has been started or if the tax returns have been filed later. A 10-year period is applicable if tax fraud is involved.

Appeal procedures

If a taxpayer does not agree with an assessment or other specific decisions made by the tax authorities, he can appeal within a period of one month after receipt of the assessment or of the decision. The tax office that made the original assessment or the first decision handles the first appeal. If no agreement can be reached the appeal can be taken to the competent Finance Court (Finanzgericht). The decision of this court can again be appealed within one month at the Federal Finance Court (Bundesfinanzhof). A direct appeal of taxpayers to the European Court of Justice is not possible. However, during a domestic legal procedure the taxpayer might request the submission of the legal issue to the European Court of Justice in a submission procedure pursuant to Art. 234 of the EC Treaty .

Non-corporate taxpayers Compliance and returns

In general, the compliance requirements for non-corporate taxpayers (individuals, partnerships) are the same as those for companies. If the income from trade or business is derived by a partnership then the partnership itself is obliged to file the return for trade tax.

Withholding tax on wages and salaries

Tax on income from employment is collected by deduction at source by the employer. When employment begins, the employee has to hand over to the employer a wage tax card (*Lohnsteuerkarte*), which includes the wage tax classification and personal allowances the employee is entitled to claim. The employer is required to deduct the appropriate wage tax from each payment of remuneration, based on tables that take into account the tax class and an appropriate proportion of the allowances claimed on the wage tax card. Although the employee owes the tax, the employer can be held liable for withholding and payment of the tax.

Foreign personnel

Foreign individuals resident in Germany are subject to the same compliance requirements as German residents. A resident status for tax purposes is assumed if the taxpayer resides for more

than a 6-month period without considerable interruptions within Germany. Taxpayers who are not resident in Germany are not usually obliged to file tax returns, unless they have certain German-source income.

This FactSheet has been prepared by BDO. Its aim is to provide background information for setting up and running a business in Germany in compliance with legislation in force in September 2004.

It is written in general terms and is not intended to be comprehensive. Before taking decisions advice should be sought from

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