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LÜBECK Business Development Corporation

Taxes on Businesses

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Taxes on Businesses

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.

Resident companies are subject to tax on their world-wide income (corporation tax, trade tax on income). Foreign companies are taxable only on German-source income. A resident company is a company that has its registered office or place of management in Germany. Vice versa, a foreign company is any company that neither has a registered office nor its place of management in Germany.

Corporation tax system

As pointed out above the uniform tax rate is 25 % for all taxable earnings, whether distributed or retained, and whether earned by a German company or by the German permanent establishment of a foreign company. In addition, the income distributed (dividend) is subject to a withholding tax of 20 %.

Corporation tax is a final burden leading to no domestic credit or refund. The double taxation that would result from taxing the dividend income received by resident shareholders is avoided by a general exemption of dividends for corporations and a 50 % dividends-received exemption for individuals (half-income method).

In addition to corporation tax a solidarity surcharge of 5.5 % is assessed on corporation tax. Together with the trade tax, this will result in an aggregate average tax burden of 37 % (depending on the location of the business, this ranges from 33 % to 40 %).

Gross income

Accounting period - The tax accounting period corresponds to the company's financial accounting period, but cannot exceed 12 months. There is no obligation to use the calendar year.

Accounting methods and income determination - A company's taxable income is derived from the annual financial statements prepared under generally accepted accounting principles (as laid down in the Commercial Code) and adjusted to comply with relevant tax law.

Stocks - are generally valued at the lower of cost and market value on the principle of individual evidence. Cost for this purpose is calculated using the average annual cost of acquisition including the previous year's closing inventory at its balance-sheet value. Last in/first out (LIFO) is generally accepted whereas first in/first out (FIFO) may only be applied for tax purposes if the real consumption of stocks takes place along these lines.

Capital gains - are normally taxed at the same rate as normal business profits. Capital losses are deductible. However, capital gains from the sale of shares in a

resident or foreign company held by a resident company or as an asset by a permanent establishment of a foreign company are generally exempt from corporation tax and trade tax. This exemption applies irrespective of the size of the shareholding, holding period or activity, or whether shares are indirectly held by a partnership. Correspondingly, capital losses or write-downs are not deductible. However, 5 % of the capital gain is deemed to be a non-deductible expense, triggering income taxes.

Furthermore, there is relief available for capital gains resulting from the disposal of real estate. The capital gain can be deducted from the cost of newly acquired real estate within a prescribed period. The period is usually four years (six years in the case of newly constructed buildings, if the construction began within four years of the disposal of the asset).

Interest income is taxable in the year in which it arises. Accruals have to be made on both sides of the balance sheet. There are no exceptions. Foreign withholding tax, comparable to German tax, can be credited against corporation tax, or, if there is no credit possible, can be deducted as an expense. However, starting from the year 2004, under the Interest and Royalties Directive interest received by a German company from an associated EU company should be free of withholding tax, with the exception of payments from a few EU countries that have a temporary derogation from the Directive.

Dividends received by a German-resident company from another German-resident or foreign company are generally exempt for corporation tax purposes regardless of minimum shareholding, minimum holding period, activity requirements or double tax treaties. For trade tax purposes the exemption is granted only where there is a minimum shareholding of 10 %. This general exemption is also applicable to German permanent establishments of foreign companies. As with the corresponding exemption for capital gains, this exemption is not lost when the investment is indirectly held through a partnership.

Although dividends from domestic or foreign companies are exempt, 5 % of such dividends is treated as a non-deductible expense, triggering a liability to corporation tax. Effectively, this means that 95 % of the dividends are tax-free, but all related costs actually incurred are fully deductible.

Royalty income constitutes taxable income. Any foreign withholding tax may either be offset against corporation tax or deducted as an expense unless no qualification differences appear. According to the Interest and Royalties Directive, starting from the year 2004 royalties received by a German company from an associated EU company are exempt from withholding taxes in most Member States.

Management fees received are taxable, irrespective of whether the services are rendered to a resident or non-resident company. They are taxable in Germany irrespective of the place of performance unless a tax treaty (permanent establishment) rules otherwise.

Non-taxable income includes contributions to capital, income from foreign branches according to relevant tax treaties and tax-exempt investment grants.

Thin capitalisation - Thin capitalisation rules have been in effect since the 1994 tax year. In addition to the general provisions on arm's length pricing between dependent companies, 'thin cap' rules apply to the funding of a company by a private or corporate domestic or foreign shareholder. The rules also apply to the financing of German branches of foreign companies and of partnerships with corporate partners.

Interest payments are recharacterised as (non-deductible) deemed dividends (hidden profit distributions), to the extent that

- the underlying loan is not just short-term,
- such loan is provided by a related party, including a major shareholder (holding more than 25% of the common stock or nominal capital), or financing through unrelated parties with a recourse to the shareholder or affiliates of the shareholder

- the annual interest is more than EUR 250,000 (exemption threshold) and
- the consideration is calculated as a portion of capital and the borrower's debt-equity ratio exceeds 1:1.5 (the same safe haven also applies to holding companies).

Where the above requirements are met, the interest deduction will be denied for corporation tax as well as trade tax purposes. Further, the payments are generally subject to 20 % dividend withholding tax, which may be limited by a tax treaty.

Interest expenses from hybrid funding (profit-participating loans, silent partnership funding, jouissance rights) are not deductible in any case.

The 'thin cap' rules and the non-deductibility of interest paid to related parties are extended to partnerships if the interest is incurred in connection with the acquisition of shares in a company from related parties.

Deductions
Depreciation - The valuation of fixed and intangible assets is based on the historic purchase price or manufacturing cost, reduced by depreciation calculated in accordance with strict rules taking into account the anticipated life of the asset and any residual value to be expected. Both the straight-line and the declining-balance methods are allowed. The declining-balance method may only be applied to movable fixed assets. The declining balance rate may not exceed two times the corresponding straight-line rate and is not allowed to exceed 20 %. Examples of normal rates are: % Buildings 2 - 5 Machinery 6.3 - 20 Office equipment 6.7 - 20 Cars 16.6 - 20 Goodwill 6.6 The tax authorities publish guidelines detailing depreciation rates to be applied to different types of assets used in various industries. If the market value of the assets is substantially lower than the book value, there is a possibility of depreciating to the lower market value. Extraordinary depreciation allowances are available in certain circumstances. In case of extraordinary depreciation the book value of the depreciated asset must be increased (in no event, however, to a value in excess of the acquisition costs) when the market value exceeds the book value to which the asset has been depreciated.

Items with a value of not more than EUR 410 may be written off in the year of acquisition. Generally, assets can only be depreciated on a pro rata basis. Special provisions apply to the depreciation of buildings.

Interest expenses are generally deductible when they become payable. Under the Interest and Royalties Directive interest paid to a related party in different EU countries is not subject to German withholding tax, if any.

Royalty payments are deductible. There is a 20 % withholding tax on royalties paid to residents of foreign countries. The statutory rate may be reduced by a tax treaty. As with interest payments the Interest and Royalties Directive exempts royalties from withholding tax where payment is made to a related EU company.

Employee remuneration and benefit payments will always be deductible if incurred in connection with a business. Deductible costs include costs for retirement plans and the employer's share of social security contributions.

Payments related to the costs of construction or acquisition of capital assets must be capitalised as part of asset costs in the balance sheet.

Insurance premiums are deductible if they are incurred in connection with the company's trade or business. Insurance premiums paid to associated companies will be subject to an arm's length test.

Bad debts can be written off, if a debt becomes wholly or partly worthless.

Management fees are deductible and should be calculated on an arm's length basis particularly if paid to a non-resident related company. The reasonable pricing of this service is closely watched by the German administration.

Taxes incurred by a company are generally deductible. However, corporation tax and the solidarity surcharge are not deductible.

Other operating expenses that qualify as business expenses are deductible including rent, repairs and entertaining. Non-deductible expenses include:

- expenses related to tax-exempt income,
- business gifts worth more than EUR 35 per recipient,
- 50 % of the remuneration of the supervisory board, and
- 30 % of entertaining expenses.

Losses

Net operating losses reduce all profits, including capital gains, of the accounting period in which they arise. Losses not used in this way may be carried back into the previous accounting period subject to a limit of EUR 511,500 (no carry-back is allowed for trade tax purposes). To the extent that the loss exceeds EUR 511,500 or cannot be carried back, such loss may first offset income up to an amount of EUR 1 million without limitation and then up to 60 % of the remaining excess income. The residual losses can be carried forward indefinitely. Losses may be pooled in case of group taxation.

Tax computation

Taking into account the deductibility of the trade tax on income, the total tax burden generally amounts to 38.15 % in the case of undistributed profits and 51.20 % in the case of distributed profits. In the latter case German-resident shareholders can normally credit the withholding tax against their own tax. Foreign shareholders can in almost all cases obtain a reduction of the withholding tax (see below).

The tax burden of a German permanent establishment of a foreign company is equivalent to that of a resident company that retains its earnings. Because dividend withholding tax is currently inapplicable to profits repatriated by a German permanent establishment to its foreign head office, the total tax burden of 38.15 % is final.

Profit repatriations to a non-EU country by a German company are generally subject to (at least) a 5% withholding tax. According to the EU Parent-Subsidiary Directive dividends paid to its EU parent are no longer subject to withholding tax (application required), provided the EU parent company has held a minimum of 25 % of the shares in the subsidiary for at least one year immediately prior to the distribution (according to a European Court decision, a holding period of one year, independent of the time between acquisition and distribution of profits, is sufficient). The total tax burden therefore corresponds to that of a German company or permanent establishment that has retained its earnings.

This privilege can also be applied to a minimum holding of 10 % if the EU country in which the parent company resides grants the same privilege.

Avoidance of double taxation

A German resident company is taxable on all profits arising from foreign sources in the same way as on income from German sources. Double taxation is avoided by use of foreign tax credit relief, available under unilateral rules. A widespread treaty network exists to avoid double taxation, either by way of exempting foreign income from German tax or by way of tax credit relief.

International participation exemption

Intra-corporate dividends are not included in income chargeable to corporation tax. This unconditional participation exemption applies to both foreign and domestic dividends regardless of the level of the holding, the holding period, or of any double tax treaty. Likewise the gain from the disposal of an interest in a foreign or resident subsidiary is also exempt from German tax. However, this exemption is subject to certain limitations, mentioned above.

Tax computation for trade tax

In addition to federal corporation tax there is also a local trade tax on income which is levied on all enterprises engaged in industrial or commercial activities. Trade tax is deductible for corporation tax purposes.

- The tax is levied on a base of 5 % of adjusted income, to which each local authority applies a multiplier ranging from 200 % to 500 %. The effective rate ranges between 9 % and 20 % of income before deducting the trade tax from the taxable base for corporation tax purposes. Trade tax is payable on

pre-tax income as determined for corporation tax purposes, with the following main adjustments.

Additions

- 50 % of interest on long-term debt related to the formation or acquisition of the business;
- 50 % of lease rental payments for equipment, if the lessor is not liable to trade tax;
- tax-exempt dividends from shareholdings of less than 10 % in domestic or foreign companies;
- losses from foreign branches and
- shares of losses from partnerships.

Deductions

- 1.2 % of 140 % of the standard value of real estate;
- income from foreign branches;
- income from partnerships;
- dividends from shareholdings of at least 10 % in domestic or active foreign companies.

As with corporate losses, trade losses can be carried forward indefinitely. The amounts available for an unlimited offset are capped at EUR 1 million. Profits exceeding this threshold may only be offset by trade losses to the extent of 60 % of the excess. No loss carry-back is available.

Group companies

Where German subsidiary companies (*Organgesellschaften*) are financially integrated into a German parent company (*Organträger*) the profit or loss of the subsidiary companies can be transferred to the parent company if the companies concerned conclude a profit and loss pooling agreement of at least five years' duration. Financial integration requires that the parent company hold directly or indirectly a majority of the voting shares in the subsidiary companies whereas aggregation of direct and indirect holding is allowed.

For profit and loss pooling, the parent company may be a German-resident company, a German-registered branch of a foreign company or, under certain circumstances, a resident partnership. The subsidiary entity has to be an incorporated business in all cases. An important precondition for obtaining acceptance of a profit and loss pooling agreement for tax accounting is that the agreement matches all prerequisites of the Commercial Code.

For trade tax purposes the same requirements apply as for corporation tax purposes.

For value added tax purposes group taxation can be achieved without a profit and loss pooling agreement. However, unlike for corporation and trade tax purposes it is still necessary to meet three integration tests of financial, economic and organisational dependency. VAT returns are filed in the name of the parent company reporting only sales made and services performed outside the group. Sales and services within the group are not taxable for value added tax purposes.

Transfer pricing documentation

As in many other countries German taxpayers are required to prepare comprehensive transfer pricing documentation concerning transactions with related parties abroad. Non-compliance with the documentation requirements can lead to severe sanctions on multinationals, such as increased ability to estimate a taxpayer's income, the shift of burden of proof, and penalties of up to 10 % of the income adjustment.

Taxation of foreign companies

A foreign company is subject to tax in Germany under certain circumstances. The most important are:

- income from trade or business through a permanent establishment or through a permanent representative (agent);
- income from real estate situated in Germany and
- other income from German sources enumerated in section 49 of the Income Tax Act.

The income from trade and business is subject to trade tax on income and to corporation tax, whereas the income from real estate is subject only to corporation tax. Other income from German sources (such as dividends and royalties) is normally subject to withholding taxes. There is no withholding tax on the repatriation of branch profits to the home country.

Germany has a wide network of tax treaties under which double taxation problems are regulated. Tax treaties can deviate from national rules. The current corporation tax rate for non-residents amounts to 25 % of taxable income plus the solidarity surcharge of 5.5 % of the tax (an effective rate of 26.375 %).

Trading as a branch
A foreign company doing business in Germany through a branch has to keep separate books for the branch. The tax liability of a foreign company on income effectively connected with the branch is determined in the same manner as that of a resident company. Expenses incurred outside Germany exclusively for the purpose of the German branch may be deducted. These can include a reasonable proportion of overheads incurred by the home office and management expenses.

If the German branch receives income that has been subject to German withholding tax (e.g. dividend income from a subsidiary), the tax withheld may be credited against German corporation tax payable by the foreign company in respect of the branch. Moreover the registered branch of a foreign company can be the parent company (O*rganträger*) of one or several German companies.

The foreign company is treated in the same way as a resident company in relation to the carry-back and carry-forward of net operating losses referred to above.

Income from German subsidiaries
Profits of subsidiaries are taxable in the same manner as those of any other resident company.

Dividends paid to a foreign parent company are paid after deduction of a 20 % withholding tax on the dividend. Tax treaties will normally provide for lower (or zero) rates of withholding tax. According to the EU Parent-Subsidiary Directive no withholding taxes may be retained under certain conditions.

Interest paid by a German company to non-residents is exempt from taxation. For thin capitalisation rules see above.

Royalties paid to non-residents with regard to intangible personal property rights used within a German trade or business attract a 20 % withholding tax on the payment. Tax treaties again provide for reductions or exemptions. According to the EU Interest and Royalties Directive, there are no withholding taxes in Germany on royalties paid to associated EU companies as from 2004. Exemption is dependent on application, however.

Service fees paid by a German subsidiary to its foreign parent must be on an arm's length basis for items such as management services and technical assistance. Withholding tax does not have to be deducted (unless for licence agreement payments). It is generally advisable to have a written agreement in place between the two parties.

Capital gains on the disposal of a shareholding in a German subsidiary are tax-exempt. However, 5 % of the capital gains on the disposal of the shareholding are deemed to be non-deductible expense, triggering income taxes.

Taxation of foreign operations
Taxation of foreign income Foreign operations of a German-resident company are taxed as follows:

Branch income In general a German-resident company will have to include the results of a foreign branch in its taxable income for corporation tax purposes (not for trade tax purposes). Relief for foreign taxes paid on foreign branch profits and withholding taxes is available against German corporation tax on the branch profits. On application, foreign taxes can be deducted from taxable income as expenses.

In case of a tax treaty providing for the tax-exemption method, foreign branch profits are not included in taxable income. If the tax-exemption method is used, foreign branch losses are not tax-deductible.

Income of foreign subsidiaries Income of foreign subsidiaries is in general not subject to German tax unless it is paid as a dividend to the German resident or it is paid to a German resident as management fees, interest, royalties or rents.

There is, however, anti-avoidance

legislation ("CFC legislation") to prevent the diversion of profits to companies in low-tax countries. The anti-avoidance legislation generally applies if companies are under the control of German residents i.e. if more than 50% of the shares are owned or considered to be owned, directly or indirectly, by German residents.

Under this legislation a German-resident company will be subject to German tax on certain passive income that was derived by a foreign company domiciled in a low-tax jurisdiction but was not distributed to its German shareholders. Low-level taxation is assumed if the passive income is subject to income taxes at a rate of less than 25 %. German CFC legislation contains a list of activities that are considered to be "active". All other items of income are considered to be "passive". The catalogue of active items lists the following:

- Income from agriculture and forestry;
- Income from manufacturing activities;
- Income from the operation of a bank or insurance business (unless the business is predominantly conducted with controlling domestic taxpayers or affiliated persons);
- Sales income (unless the goods are purchased and delivered from within Germany from a controlling domestic taxpayer or an affiliated person and sold to a third party abroad, or where the goods are purchased from a third party abroad and sold and delivered into Germany to a controlling domestic taxpayer or an affiliated person);
- Service income (unless the services are performed with the assistance of either a resident controlling share-holder or a person considered to be affiliated with such a taxpayer or are rendered to a controlling taxpayer);
- Rental and royalty income (subject to very stringent limitations);
- Income from the borrowing and lending of money, if the funds are borrowed exclusively on foreign capital markets and are lent to active businesses located outside Germany;
- Dividends from companies;
- Capital gains from the disposal of another company.

Passive income of a foreign company with a capital investment character is taxable in Germany irrespective of the distribution of profits if the German taxpayer owns a 1 % share.

It is expected that this anti-avoidance legislation will be amended in the near future.

Capital Gains
Gains on the disposal of shares in foreign subsidiaries are tax-exempt without a minimum shareholding or minimum holding period requirement. However, 5 % of the capital gains on the disposal of the shareholding are deemed to be a non-deductible expense, triggering income taxes.

Gains on disposals of foreign branch assets are subject to corporation tax but not to trade tax. They may be exempt from corporation tax under a tax treaty.

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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