German Tax Reform – First Key Points

Cabinet Resolution of July 12, 2006 – a disappointment?

It sounded too good to be true, and so it has proved. On taking office the members of Germany’s coalition government had promised a simpler tax system with lower tax rates. They undertook to make “far reaching changes to .. [the] corporate tax system and [to] set internationally competitive rates of tax”.

The stated aim was to make Germany a more attractive place of business, in particular, to check the migration of German businesses to low tax jurisdiction, and to attract more inbound investment.

The key points of the proposed reform were finally approved by the Federal Cabinet on July 12, 2006, and are less radical than had been hoped. We now expect more moderate reforms, which will cut rates but also broaden the tax base to protect tax revenues. The more limited reforms are now scheduled to take effect in 2008, with detail to be finalized this autumn and the legislative process expected to start at the end of 2006 / early 2007.

The main features of the reform which have now emerged are as follows.

I. Good News: Corporate Income and Trade Tax Cuts

- The corporate income tax rate will be cut from 25 percent to 12.5 percent. Corporate income tax (Körperschaftsteuer) will be renamed federal business tax (förderale Unternehmensteuer).
- Municipal trade taxes are not to be abolished, as hoped, but rates are to be cut by 25 percent. This would leave trade taxes in the range of 7.5 percent to 15 percent. Trade tax (Gewerbesteuer) will be renamed local business tax (kommunale Unternehmensteuer).
- There will be a targeted maximum combined corporate and trade tax burden of 30 percent.
- To simplify business taxation, the intention is to introduce a single common tax base for both the new federal business tax and the new local business tax.
II. Bad News: Broadening of Tax Base

- To recoup around 3 billion of the estimated eight-billion-euro revenue shortfall resulting from the tax cuts in its first year, the cabinet plans that the common tax base for the new local and federal business tax should be broader than that of the existing systems.

- Although the exact approach is still under discussion, the most probable change would be the disallowance of half of all a taxpayer’s interest, rental, lease and royalty payments. Corporate taxpayers are criticizing this proposal as it could turn loss-making companies into taxpayers. However, politicians favour it as they believe it could prevent the transfer of taxable profits to low tax jurisdictions through debt financing. Clearly, the partial non-deductibility of interest expenses would have a significant effect on tax planning and could significantly damage the German leverage finance market.

- Other alternatives discussed envisage a new “minimum taxation” (so that only a certain percentage of a given year’s taxable profit could be reduced by interest expenses etc.) or an increase in real estate tax (Grundsteuer) for commercial real estate.

III. Taxation of Partnerships

- A federal business tax rate cut would only ease the tax burden of corporations. The Government’s intention is, however, to equalize the tax burden on partnerships and corporations. How this would be achieved is still under discussion.

- In Germany, partnerships are subject to trade tax/local business tax at the partnership level and income tax at the level of the partners. A proposal to apply a single common rate of income tax to retained partnership profits, being the new federal business tax rate of 12.5 percent, is now being discussed. Currently, corporate partners’ profits are subject to corporate income tax, with individual partners instead paying personal income tax at the individual’s applicable tax rate, which can be as high as 48 percent. Profits are taxed at partners’ level irrespective of whether they are distributed or not.

- An alternative also under discussion would be for retained or distributed profits not to be taxed provided they are reinvested within a certain period of time.

IV. Personal Income Taxation of Dividends and Capital Gains

- With respect to personal income taxation a definitive withholding tax (flat tax) on interest and dividend income as well as capital gains (except from real estate) will be introduced. The tax rate will be 30 percent in 2008 and 25 percent as of 2009. The intention of this measure is to prevent investors from investing abroad and to attract repatriation of capital invested abroad.
• Currently, capital gains realized from the disposal of shares that are not held as business assets are only taxable if (i) the disposal takes place within one year after the acquisition of the shares or (ii) the participation is equal to or exceeds 1 percent of the stated share capital of the company. It’s proposed that these exemptions be abolished, which means that capital gains are always taxable.

• The definitive withholding tax would be levied on 100 percent of the dividends received or the capital gains obtained. The so-called half-income system, according to which only 50 percent of the dividends or capital gains were subject to individual income tax, will be abolished.

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If you have any questions about this memorandum, please call your regular Fried Frank contact or one of the attorneys listed below.

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