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Wolfgang Kessler is the director of the tax department of the business and economics faculty at the University of Freiburg and a partner with Ernst & Young in Freiburg, Germany. The views expressed here are entirely his own. Rolf Eicke is his assistant at the tax department of the University of Freiburg. E-mail: Wolfgang.Kessler@tax.uni-freiburg.de and Rolf.Eicke@tax.uni-freiburg.de

One of America's most beloved poets, Robert Frost, described in his poem "The Road Not Taken" how he struggled to decide which road to take "in a yellow wood." Eventually he chooses the "one less traveled by" and proclaims:

I shall be telling this with a sigh
Somewhere ages and ages hence:
Two roads diverged in a wood, and I —
I took the one less traveled by,
And that has made all the difference.

The German legislature had to decide which road to take after the need for tax reform was confirmed — either the mainstream or the road less traveled.

Major industrial countries tend to follow the mainstream, cutting corporate tax rates and simultaneously broadening the tax base. Countries on the mainstream path also want to tighten antiabuse provisions such as the thin cap rules and, in Germany, the anti-treaty-shopping rules, described in our previous column. (See *Tax Notes Int'l*, Apr. 23, 2007, p. 377.) However, on the mainstream, many undesirable consequences of preferential measures reduce much of the satisfaction of tax reform.

Nonetheless, Germany decided to follow the mainstream, with the disadvantage of being unable to "make all the difference" regarding peer competitors for the most attractive location to invest in Europe. However, it eventually came up with a good reform that helps both domestic and foreign companies invest in the country. The reform is already a political success, although it is too early to estimate its economic success.

The Tax Reform 2008 just passed the Bundestag and will pass the Bundesrat. Even though the total amount of the tax cut is €30 billion, the net revenue loss is estimated to be only €5 billion — a magic number in the drafting process, as the left-wing Social Democrats were unwilling to spend more than that on reform.

Tax Rate Cut

The overall tax rate for corporations drops from 38.6 percent to 29.83 percent, which includes a 15 percent corporate tax, a 14 percent trade tax, and a 0.83 percent solidarity charge.

Trade tax can no longer be treated as a deductible business expense. Since the total corporate tax rate figures seem to have a magical influence on investors, the cut will improve Germany's position among the group of countries that are the favorite places to invest in Europe. The only downside to the rate cut is the estimated 9 percent increase of the tax base. To some extent, the tax rate cut was driven by the idea behind the Laffer Curve. Legend has it that Prof. Arthur Laffer drew the now-famous curve more than 30 years ago on a napkin at a dinner party (guests included U.S. Vice President Dick Cheney and former Defense Secretary Donald Rumsfeld) to show that a tax cut can increase revenue.[1] The German government hopes for the same, as it estimates additional revenue of €3.9 billion for 2008. The assumption is that both legal tax avoidance and illegal tax evasion become more unattractive — which might be correct from a static point of view, but causes some doubts from a dynamic perspective. As long as neither the OECD nor the EU have successfully incorporated a tax cartel, a tax cut in the largest economy in Europe creates more tax competition. Gordon Brown, the future British prime minister, has already announced a tax cut in the United Kingdom, and other major European countries will surely follow. However, the government estimated only self-finance figures, not the rightness of the chosen road.

[1] *See* Arthur B. Laffer, "The Laffer Curve: Past, Present, and Future," backgrounder 1765, The Heritage Foundation, June 1, 2004, *available at* http://www.heritage.org/Research/Taxes/bg1765.cfm.

Earnings Stripping Rule

A new earnings stripping rule (*Zinsschranke*) was introduced that limits the maximum amount of interest deductions to 30 percent of EBITDA (earnings before interest, tax, depreciation, and amortization).

Lobbyists managed to convince the legislators to choose EBITDA as the relevant base figure instead of the longtime favorite earnings before income tax (EBIT). The beneficiaries of this modification are companies with high investment expenses in Germany.

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The administration said the main reason for the *Zinsschranke* is its use as a counterfinance instrument to ensure that the budget loss does not exceed €5 billion. The *Zinsschranke* is also meant to drive finance costs out of Germany, thereby stopping the shifting of profits abroad. Lawmakers have become more disturbed by the tax planning practices of two "global players" that deducted excessive interest expenses from their German tax base, with significant effects on their German tax liabilities.

From our point of view, the *Zinsschranke* is the bad part of an overall good story. The legislature started out targeting a few companies, and it ended up setting a trap for many.

Withholding Tax on Capital Income

A break in the tax system will occur due to the introduction of a withholding tax for interest income, dividends, and all short or long-term capital gains on the disposition of portfolio shares or debt instruments and derivatives realized by individuals as nonbusiness income. Starting in 2009, that kind of income will be subject to a flat withholding tax of 25 percent plus a solidarity surcharge. The current half-income system (*Halbeinkuenfteverfahren*) that exempts 50 percent of the dividend income and other types of investment income of individuals from taxation will be abolished. If the investment is held by a company and is part of the business assets, the new part-income system (*Teileinkuenfteverfahren*), which exempts 40 percent of the investment income from taxation, will apply.

The reason for the change is to ensure the taxation of capital gains in Germany and to stop tax evasion. To justify the preferential taxation of capital income, Finance Minister Peer Steinbrück said that "25 percent on some income is better than 50 percent on nothing." The measure recognizes the reality of fast-moving capital in a globalized world. Germany's response is to move away from a synthetic tax system, which applies the same tax rate to all types of income, to a dual income tax system, which creates a gap between capital income and noncapital income.

Retained Partnership Profits

Because partnerships are treated in Germany as a transparent entity, the partners are taxed at their individual tax rates, which range from 15 percent to 48 percent, including a solidarity surcharge. Therefore, some partners are better off and some are worse off when compared to the shareholders of a corporation, who, after profits are taxed on the level of the corporation, will be subject to the new flat withholding tax of 25 percent (plus a solidarity surcharge) on nonbusiness income. Legislators enacted a preferential treatment for retained partnership profits (*Thessaurierungsbeguenstigung*). Individual partners and owners of proprietary businesses using the accrual method may elect a preferential tax rate of 28.25 percent plus a solidarity surcharge on retained profits. On distribution, the income will be taxed at the new flat withholding tax rate of 25 percent plus a solidarity surcharge. Partners are eligible for this election if they are entitled to more than 10 percent of the profits or if profits exceed €10,000. This preferential treatment does not lead to an overall tax advantage because on distribution, the total tax burden is approximately as high as if the income was distributed to the partner in the first place.

Other Changes

Other major changes include the taxation of functions and other intangible assets that are shifted abroad and the broadening of the trade tax base regarding all interest expenses. Also, loss carryforward opportunities after the acquisition of a company will be further restricted. If within five years, between 25 percent and 50 percent of the loss entity's shares were directly or indirectly transferred to an acquirer or a person related to the acquirer, the loss carryforward that existed at the time of ownership change will be proportionally forfeited. Any more than 50 percent transfer of shares will result in a complete loss of carryforward credits. This new rule has received a lot of criticism from companies that need capital from private equity funds to avoid insolvency. It is hoped that the legislature will incorporate a preferential rule for the acquisition of insolvent companies in the coming Private Equity Act.

One of the most detrimental measures for investors is being abolished — the declining balance depreciation. The straight-line depreciation will be the only applicable depreciation method.

Winners and Losers

It is always difficult to identify winners and losers of a reform, but we will try. Small or midsize entities that are not financed with too much debt are the winners; large corporations with a strong need for debt are worse off, mainly because of the new earnings stripping rule.

Conclusion

International investors in Germany will find appealing items in this tax reform. However, investors must take the bad with the good. For foreign investors, the bad is the new thin cap regime (*Zinsschranke*), the severe restrictions for loss carryforwards of an acquired company, and the abolishment of the declining balance depreciation. This new regime is a major reason why German tax law has become more complex under the reform.

For German tax reform, the road not taken was uncertain but potentially more rewarding. At least for now, Germany is a better place in which to invest. ◆