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by Wolfgang Kessler and Rolf Eicke

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Welcome to the German Dual Income Tax

by Wolfgang Kessler and Rolf Eicke

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The northern lights are a spectacular sight and one of the features that make the Nordic countries of Norway, Sweden, and Finland special. Another unique aspect of those countries is the way they tax labor and capital income. In the 1990s, they were the first countries that treated capital income more favorably than labor income by establishing a dual income tax. At first glance, this distinction seems to be unfair because it benefits those that already have a lot of money. But the rationale behind this notion is quite simple — it is better to pamper capital with a lower rate than to let it vanish with no contribution to the budget.

The German government is now incorporating the Nordic idea of a dual income tax into German tax law. What sounds very simple is actually monumental, and it is causing a fundamental inconsistency within the German income tax system. Currently, Germany applies a synthetic income tax system in which all income is added together to be taxed at one progressive tax rate, depending on the achievement potential of the taxpayer. Simply put, the more you earn, the more taxes you pay. That principle is a core pillar of the German income tax system. From January 1, 2009, that pillar will crumble because of the so-called *Abgeltungsteuer* (payment in lieu of tax), a flat and final withholding tax on all kinds of nonbusiness capital income such as dividends, interest, and capital gains. The reasoning behind this measure is to stop capital flight abroad and to simplify the taxation of capital income. However, there is one exception: The taxpayer can elect a conventional assessment of the capital income.

Sven Nackstrand/Agence France Presse

The Aurora Borealis, the northern lights, in Ostby, Sweden.

Legal Framework

Currently, individuals that receive dividends are taxed only on half of their dividend income according to the half-income procedure (*Halbeinkuenftteverfahren*). That system will be abolished in favor of the 25 percent plus 5.5 percent solidarity surcharge flat and final withholding tax, adding up to a 26.375 percent tax burden. (See Figure 1.) However, if the dividends are earned through a partnership or branch as business income, the half-income procedure will live on under a new name — the part-income procedure (*Teileinkuenfteverfahren*), according to which 60 percent of the dividend income will be attributed to the partners and 40 percent will be tax exempt.

There is not a lot of change regarding interest income of individuals. Currently, 30 percent of the interest income is withheld at source and credited

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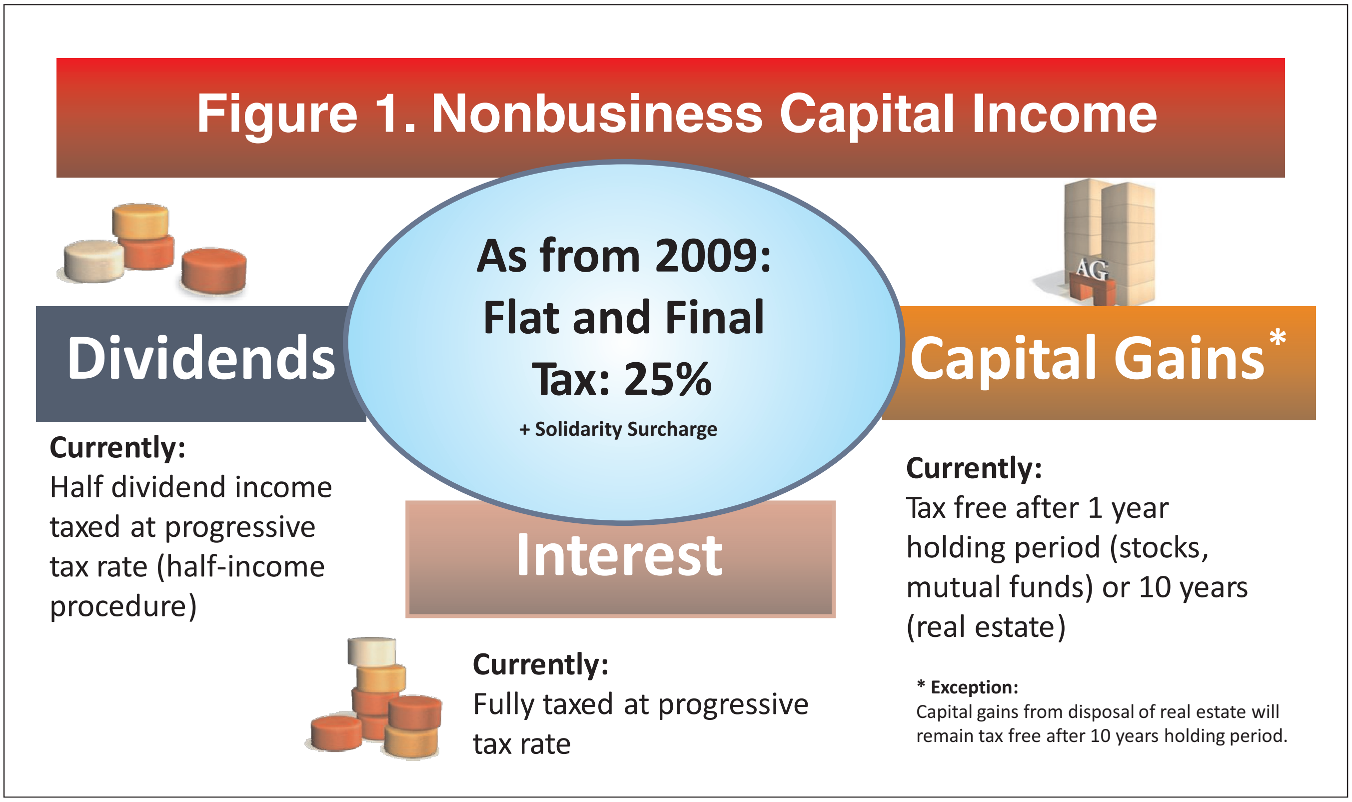

against the tax liability that is due on all income and assessed on the annual tax return. From 2009, only 25 percent plus a 5.5 percent solidarity surcharge will be withheld and no assessment will be necessary.

Moreover, the current system provides for a full exemption from capital gains taxation if an individual realizes capital gains on the disposal of portfolio shares or shares of mutual funds after a one-year holding period. Also, all short- and long-term capital gains on the disposal of portfolio shares, mutual funds, debt instruments, and derivatives (certificates) will be subject to the new final withholding tax. The only capital gains that remain untouched and untaxed are real estate profits after a holding period of 10 years.

Regarding all dividend, interest, and capital gains income, actual costs such as finance, depot management, and consulting costs cannot be offset. Instead, there is a lump sum deduction of €801 for singles and €1,602 for couples. That constitutes a massive violation of the principle that only genuine net profits are subject to taxation.

Most complex is the way in which the new rule governs loss aggregation between the different types of income and within the group of capital income. In general, profits and losses are set off in between all income brackets. From 2009, capital income will be excluded from this rule; only profits and losses within the capital income bracket can be offset. Another exception will apply for income from stock investments — they will follow a separate profit and loss aggregation system. Losses from stock investments can only be set off against gains from stock investments of the current calendar year, with an opportunity to carry them forward. That is another severe violation of the fundamental principle of net profit taxation and can hardly be justified by revenue loss considerations due to the volatility of the stock market, as the government argues.

A more liberal aggregation rule applies for profits and losses from mutual funds, because they can be set off against interest or dividend income.

The only good news is the grandfathering rule, which provides that taxpayers acquiring stocks or shares of mutual funds before January 1, 2009, will still receive the full exemption after the holding period has expired.

Regarding all of the income mentioned above, no assessment is necessary, as the tax is withheld at source — at the level of the corporation or bank. Nonetheless, taxpayers can opt to be assessed along with the other income.

Simplification?

Against that background, the simplification of capital taxation as one of the major reasons for the

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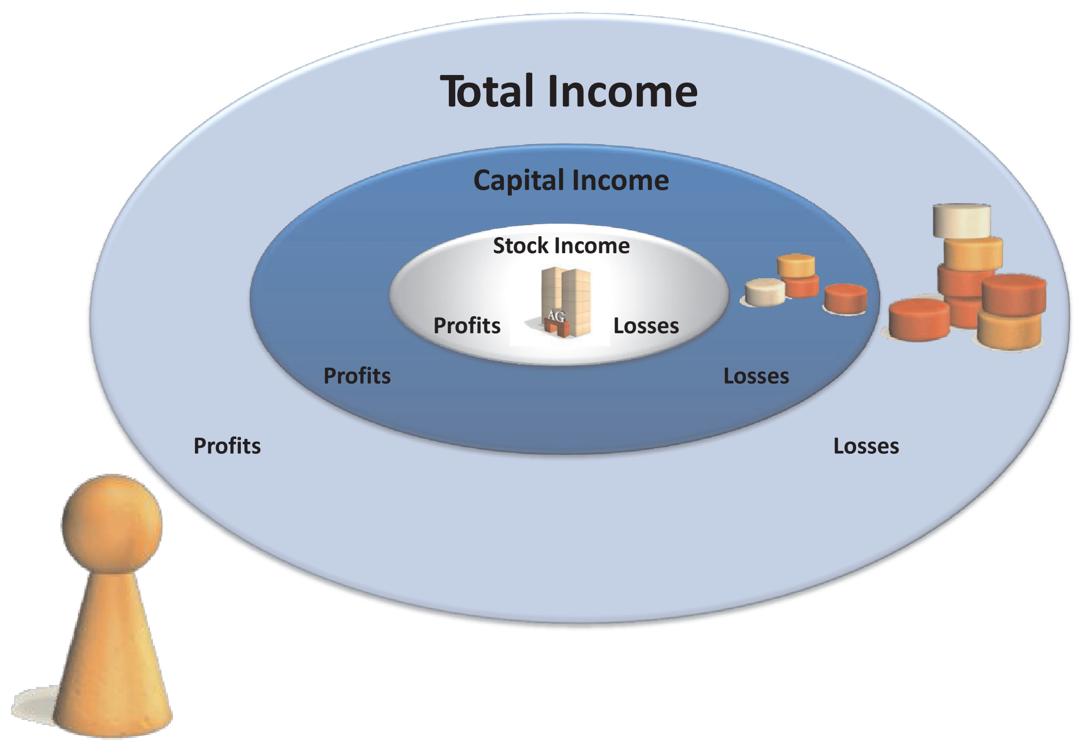
Figure 2. Aggregation of Profits and Losses



new regime must be doubted. It is simpler for taxpayers with a marginal tax rate above 26.375 percent, that have one bank account to generate capital income, and that do not own any mutual funds. In that case, the bank will do all the work.

In all other cases, an assessment is still most likely necessary, as that is the only way to set off losses or deal with the periodic taxation of mutual funds.

Effects

Capital income will receive better treatment than labor income. That comes even more as a surprise considering the fact that this piece of legislation has been drafted by a coalition in which the Social Democrats not only participate in but are also in charge of the Ministry of Finance. If we take for granted that most Social Democrat voters are taxed more on labor than on capital income, they are worse off.

Because the tax on capital income is lower than on income from labor or business, the new regime will have a great impact on the decision-making of both private and business investments, giving rise to some tax arbitrage possibilities.

Inherent to the new system is a discrimination of equity-financed real investments or the equity financing of companies compared with financial investments or debt financing of a company. Debt-financed investments are taxed at a rate of 29.87 percent, compared with 48.33 percent for equity-financed investments. The discrimination of equity-financed real investments leads to two consequences. First, since only equity-financed real investments sustainably create jobs, the new decision-making rationale prevents job creation. Second, to achieve a posttax profit of 7.5 percent, a real investment has to earn approximately 15 percent on a pretax basis, whereas finance investments have to earn only 10 percent. Hence, an individual would rather finance a rental house or apartment project with debt and take the equity to the bank,

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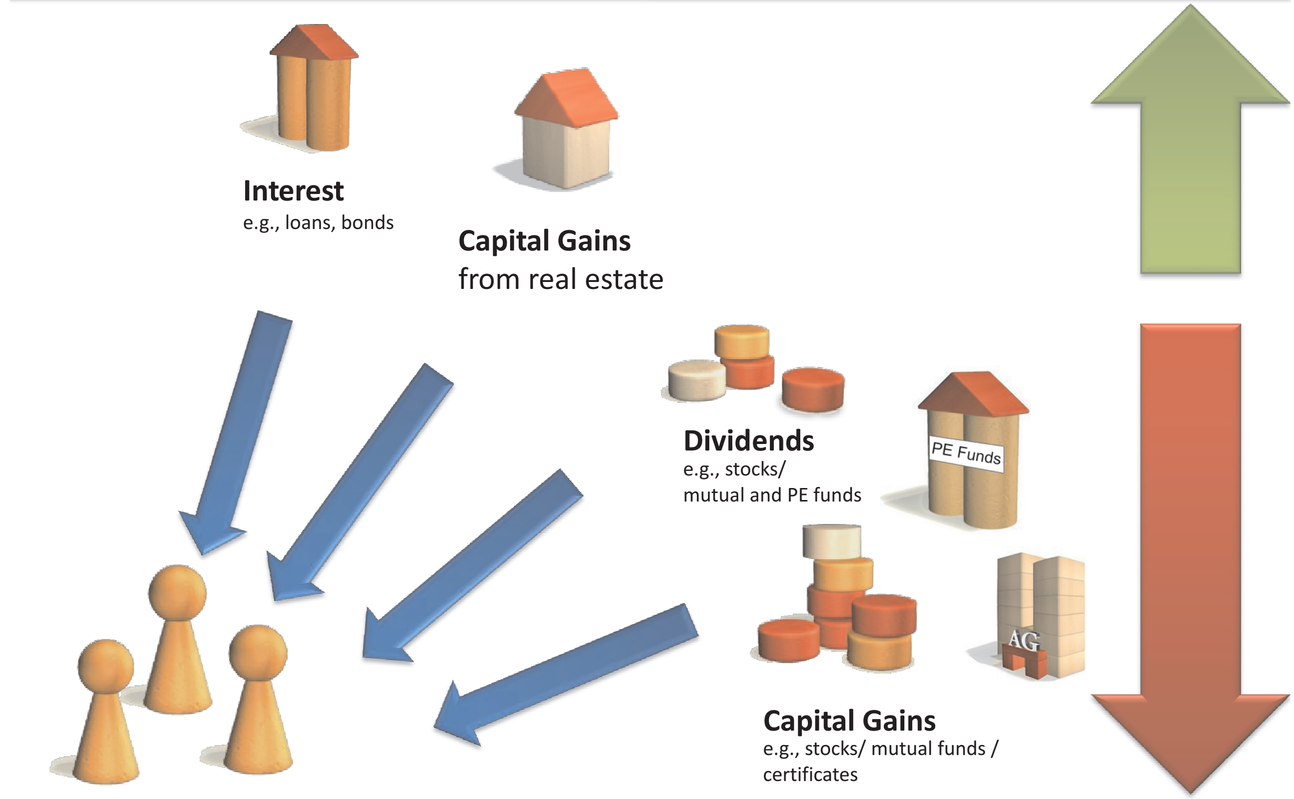
Figure 3. Winners and Losers



because the interest income thereon will be taxed at a lower rate and the interest payment for the loan can be fully deducted from the rent and lease income.

On Capital Gains

Germany is currently a paradise for taxpayers when it comes to the taxation of capital gains from private stock market investments. That is because gains from the disposal of stocks are not taxed after the expiration of a one-year minimum speculation holding period. Under the new regime, such gains will be taxed at 25 percent plus a 5.5 percent solidarity surcharge — 26.375 percent without any holding period. It does not take a fortuneteller to predict that private capital gains from stocks are the biggest losers of the reform. In fact, the new regime is a major strike against private stock market activities in a country whose citizens continuously struggle to cope with their risk aversion concerning stock market investments. Unlike many other major industrial countries, private wealth management in Germany is much less focused on stocks and more focused on safer investments such as real estate and bonds. Also, the average German employee scarcely benefits from the huge profits of private equity funds because his retirement funds are to a large extent investment beyond the scope of the stock or private equity market. As time went by, this behavior needed to change to guarantee the current standard of living. Yet, after the new economy's bubble burst in 2001, many Germans quit their stock market adventure.

Private investors in mutual funds are a little bit better off because losses can be aggregated with interest or dividend income. Best off are those investors with capital gains from the sale of real estate, since their profits will remain untaxed after the 10-year holding period lapses.

On Interest

Taxpayers with high interest income are also winners in this reform. Currently, they pay up to 47.48 percent. As the rate decreases to 26.375 percent, there is a maximum relief of 21.1 percent. For sure, the international financial service industry

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will react by offering more products involving interest gains to German taxpayers.

On Dividends

Taxpayers with dividend income will be worse off in the future, since all dividends will be subject to the tax base. The only upside is the aggregation opportunity with interest and capital gains (except from stocks).

Winners and Losers

As Figure 3 shows, taxpayers with interest income are the winners in the reform, whereas private capital gains, except for those from real estate, will face severely detrimental tax consequences.

Actions of the Hour

As January 1, 2009, approaches, taxpayers have several opportunities to react. First, long-term stock or mutual fund investments can be placed before this date to benefit from the grandfathering rule that capital gains will still be tax free even if sold after January 1, 2009. Second, investments to derive interest income can be very attractive even before the reform. The goal is to invest now and gain only little or no interest until January 1, 2009, to conduct a tax-rate arbitrage. Options are low-interest bonds bought today that remain the privilege of tax-exempt capital gains on disposal even if they are disposed after the new regime enters into force, and zero bonds that delay interest income until enforcement of the *Abgeltungsteuer*.

In any case, the taxpayer must choose future capital investments wisely enough to still be able to afford a trip to view the northern lights — after taxes. ◆

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