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Featured Perspectives

Germany's Partnership Tax Regime: A Response to U.S. Check-the-Box Regs?

by Wolfgang Kessler and Rolf Eicke

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You can't blame everything on the Romans. Even though they introduced the legal framework of partnerships and corporations in Germany and far beyond, the reason why the taxation of partnerships is so complex is not their fault. Put simply, once individuals with different characteristics are taxed based on their business activities and only on a single level, the complexity begins.

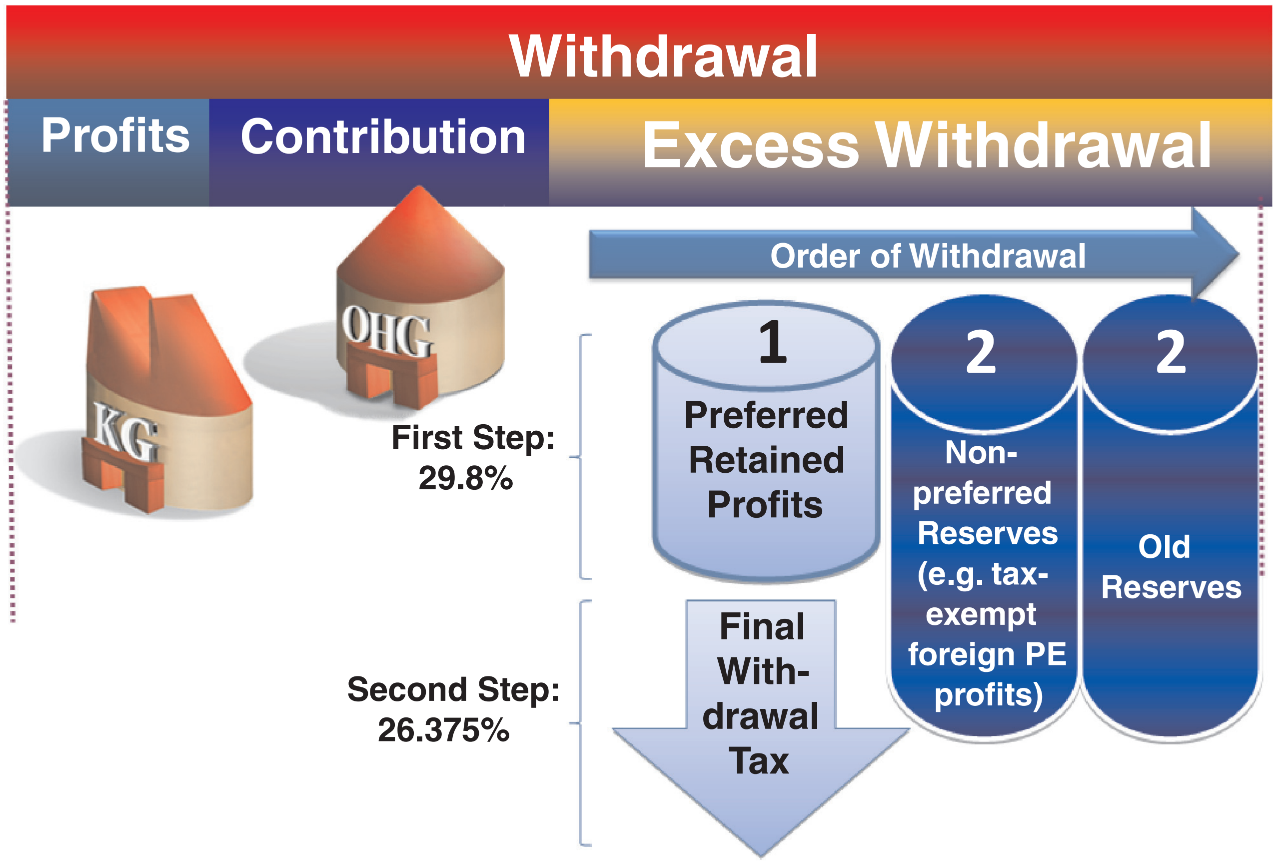
Time and again, tax jurisdictions target this complexity by attempting to assimilate the tax burden of partnerships to that of joint stock companies and their shareholders. Yet history proves that instead of pouring water on the fire to alleviate complexity, lawmakers use oil. A prominent example is the introduction of the check-the-box regulations in the United States. Another one is the new German preferential treatment of retained partnership profits (*Thessaurierungsbegünstigung*). One questions whether the most sophisticated works of Johann Wolfgang von Goethe are easier to grasp than this new rule. Maybe it is impossible for lawmakers to avoid a trade-off between less complexity and more tax neutrality among partnerships and corporations. Rules that provide for more tax neutrality almost automatically bring more complexity; it's a vicious circle.

From the perspective of a German shareholder or partner, the different technical treatment for tax purposes would not be a major problem if the tax rates and the overall tax burden were similar. Yet this is by no means the case. Partners in Germany are taxed at their individual progressive income tax rate, while shareholders are taxed on half of their dividend income (*Halbeinkuenfteverfahren*) after the distributing corporation is taxed at about 38.68 percent (corporate tax, trade tax, and solidarity surcharge).

Under the current regime, measuring the performance of one legal form over another is impossible unless one has scrutinized the individual situation of the shareholder or partner. According to the current regime, a partnership is the better choice if the owner has a low marginal tax rate or if the company distributes all profits. The total tax burden on income from a corporation that distributes all profits is currently higher than 50 percent. That is one of the reasons why 80 percent of all German companies are partnerships.

Nonetheless, the concern regarding partnerships has been the improvement of international competitiveness by increasing the equity quota of partnerships and the establishment of tax neutrality between the legal forms. The latter means that for tax

Figure 1. Partnership Taxation of Retained Profits



purposes, it should not matter whether the taxpayer is a corporation or a partnership, or whether the company is financed with debt or equity. Currently, in a comparison of the ownership of partnerships (with corporations at the top end of the tax scale), there is a gap of 7.5 percent in favor of partnerships. Hence, one thing that cannot be derived from these figures is the need for more beneficial partnership taxation. However, against the background of the major corporate tax rate cut in 2008 from 25 percent to 15 percent, the tax treatment of partnerships had to catch up.

New Regime

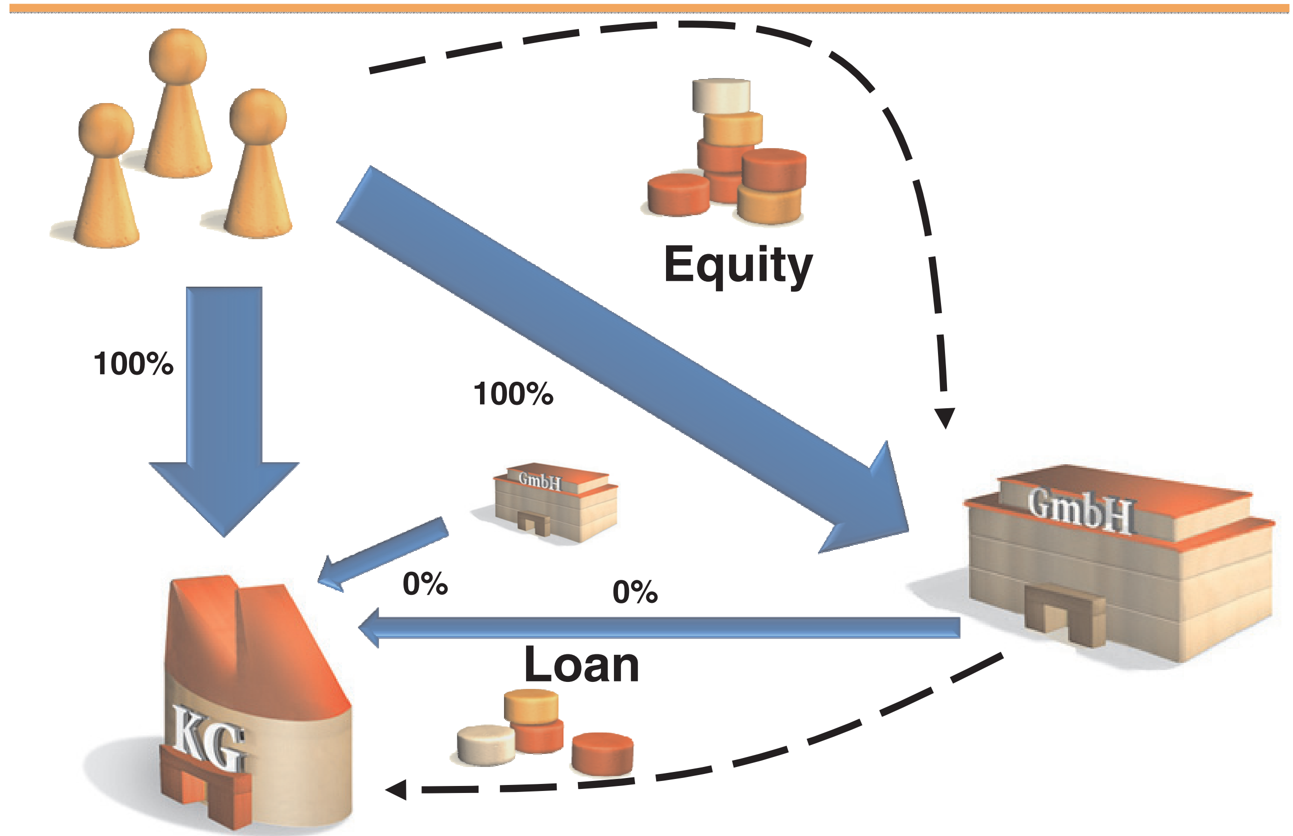
To reconcile the overall tax burden of partners with corporate shareholders, the legislature will enact a comprehensive set of rules, which are not easy to grasp at first glance. The new regime is expected to be incorporated in section 34a of the Income Tax Act and to enter into force on January 1, 2008.

In a nutshell, the new regime of partnership taxation for retained profits would involve two steps. (See Figure 1.) First, the preferred profits would be taxed at a low preferential tax rate. Second, perhaps after many years, upon withdrawal, those preferred profits would be subject to a final withdrawal tax.

Individual partners with a minimum interest of 10 percent are taxed at the preferential flat tax rate of 29.8 percent, including the solidarity surcharge for retained regular income from partnerships. They can choose what percentage of the retained profits should receive the preferential treatment. The beneficial treatment does not extend to such tax-exempt profits as those from a foreign permanent establishment.

On withdrawal of the tax-preferred income, the individual partner will be taxed at 26.375 percent,

Figure 2. KG Model



including the solidarity surcharge (final withdrawal tax). This is the rate at which dividends of individual corporate shareholders will be taxed beginning in 2009 by way of a flat and final tax (*Abgeltungsteuer*).

Importantly, the withdrawn partnership profits are subject not to the *Abgeltungsteuer*, but to a procedure that is similar. We emphasize this fact because there is a frequent misconception in German literature. The major difference between the final withdrawal tax and the final tax in terms of the *Abgeltungsteuer* is that the latter provides the opportunity to the taxpayer to choose an assessment.

On withdrawal, the current profits are deemed to be withdrawn first; therefore, the profits from non-preferred income or old reserves are only second in line and cannot be withdrawn without triggering the final taxation. If the partnership follows the wrong withdrawal policy, some "old" profits will be trapped. Because of this statutory order of withdrawal, old retained profits are locked in. Accordingly, the current tax planning measure is to take out these old profits before the new regime enters into force. Yet this order does not apply regarding withdrawals for purposes of estate and gift taxation.

Winners and Losers

On average, the advantage of choosing the preferential tax rate is about 11 percent to 18 percent, depending largely on three things: the individual tax rate of the partners, how the company is financed, and how much income is retained. According to government figures, the preferential tax treatment of partnerships decreases revenue by €4 billion per year. We believe the revenue loss will be higher.

For big partnerships, with partners taxed at the top end of the individual income tax scale, the preferential treatment is always the better choice. Even though on aggregate, the preferential tax rate plus the final flat tax is higher than if the profits were withdrawn in the first place, this disadvantage will be compensated by timing effects and compounded interest advantages.

If the partner is not in the top income tax bracket — that is, an individual marginal tax rate of below 29.8 percent — the new regime is not advantageous. If the individual marginal tax rate of a partner is 30 percent, profits must be retained for almost 50 years for benefits to be derived under the new regime.

In sum, the preferential tax rate on retained partnership profits is more beneficial:

- the higher the marginal tax rate of the partner is;
- the higher the interest advantage is compared to a private investment; and
- the longer the period of retention lasts.

The new regime has managed to bring about a fairly equal taxation regardless of the underlying legal form. It slightly erodes the dualism between transparent and nontransparent taxation and its different consequences for tax purposes. The advocates of the diversity justified this different treatment by saying that shareholders and company assets are separated in a corporation whereas they are linked to each other in a partnership. The German Federal Tax Court recently upheld this view, ignoring that the underlying company law has already accepted a separation between company assets and partners, distinguishing between a company and a private sphere.

Planning Proposals: The KG Model

The best of both worlds can be achieved with the KG model. (See Figure 2.) The advantages of a low tax rate for corporations (here, GmbH) and the possibility of crediting the trade tax against the income tax of the partners in a partnership (here, KG) can be combined. In this model, individuals hold 100 percent of the shares of both a GmbH and a KG, of which they are limited partners. The GmbH serves as a general partner of the KG to limit the liability but has not contributed any capital to the KG.

If the partners endow the GmbH with equity (for example, old retained earnings), the latter can perform both a liability limitation function and a finance function by granting loans to the KG. The advantage is that the interest payments of the KG alleviate its income, and the interest income is taxed at the low corporate tax rate of 15.825 percent, including the solidarity surcharge. Figuring that the preferential tax rate for retained partnership profits is 29.8 percent, the advantage of this structure is 13.975 percent. Moreover, the complete trade tax credit, which can be used to set off the partner's individual income tax liability, rests with the partners. Perfectly planned and implemented, the KG income equals the total trade tax credits of the partners. In that case, the partner's income tax liability would be eliminated by the simultaneous funneling of a maximum share of profits to the low-taxed GmbH. However, one of the prerequisites is that the KG must have high and stable profits to make this structure successful. To avoid the accrued capital of the GmbH being subject to full liability, a second GmbH can be implemented as a limited partner.

Above and beyond the KG model, all tax planning has to focus on the avoidance of the final taxation on withdrawal to receive a tax-efficient result. From a group tax planning perspective, the new regime motivates taxpayers to establish two different units. One unit retains profits and another unit distributes them. Further, tax planning considerations have to pinpoint and assess how the retained profits can be reinvested: either in the company operations or in investments that are subject to the new flat and final withholding tax (*Abgeltungsteuer*) of 25 percent plus the solidarity surcharge.

Also, the new low preferential tax rate brings about a major planning problem for U.S. investors. By retaining partnership profits, they risk creating excess tax credits. Most importantly, the crucial and still unanswered question is to what extent the final withdrawal tax can be credited against the U.S. tax liability according to both the double tax treaty and national law. A U.S. investor has three questions to consider:

- How is the partnership income qualified?
- If the final withdrawal tax is levied many years later, what is the effect for the crediting?
- Is the new preferential treatment of retained partnership profits considered a branch profits tax for U.S. tax purposes?

Conclusion

At the top end of the tax scale, the difference in taxation between a partnership and a corporation will decrease from 7.5 percent to 0.83 percent in favor of the partnership. But if the income tax rate is not in the highest tax bracket, a partner will in most cases be better off than a shareholder. However, a general statement concerning the taxpayer group that is not at the top end is not possible because there are several options to choose from, including these two: First, partners in the middle tax bracket will not choose the new preferential treatment of partnership income; second, at the lower end of the individual income tax scale (meaning a marginal tax rate below 29.8 percent), corporate shareholders will elect the tax assessment instead of the new flat withholding tax.

In the end, the new partnership taxation in Germany is only a response to the U.S. check-the-box regime insofar as it also targets unjust tax treatment of partnerships compared with corporations and vice versa. It does not change the transparent nature of a partnership for tax purposes. Plus, the new partnership regime in Germany is not an option that leads to a binding classification for at least a couple of years. Rather, it is a sole "tax-rate option," for it grants a lower tax rate for retained profits that for a while makes a partner of a big partnership feel as if he is taxed like a corporate shareholder. We endorse this new regime as a means to enhance both tax planning and the international competitiveness of German partnerships. Exploiting the new opportunities for partnerships might very well be a rewarding avenue in the tax structure road map. ◆