Doing Business in Germany 2008

November 2008

BDO International

DOING BUSINESS IN GERMANY 2008

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Introduction

The aim of this publication, which has been prepared for the exclusive use of BDO Member Firms and their clients and prospective clients, is to provide background information for setting up and running a business in the Federal Republic of Germany, in compliance with the legislation in force on 1 May 2008. It is of use to anyone who is thinking of establishing a business in Germany as a separate entity, as a branch of a foreign company or as a subsidiary of an existing foreign company, and to anyone who is considering coming to work or live permanently in Germany.

The publication describes the business environment in Germany and outlines the financial and legal implications of running, or working for, a business in Germany. The most important issues are included, but it is not feasible to discuss every subject in detail within this format. Accordingly, *Doing Business in Germany* 2008 is written in general terms and is not intended to be comprehensive. If you would like to know more, please contact the BDO Member Firms with which you normally deal, who can provide you with information on any further issues and on the impact of any legislation subsequent to 1 May 2008.

BDO International is a worldwide network of accounting and consulting firms, called BDO Member Firms, serving international clients. Each BDO Member Firm is an independent legal entity in its own country. The network is coordinated by BDO Global Coordination BV, incorporated in Germany, with an office in Brussels, Belgium, where the Global Coordination Office is located.

Founded in Europe in 1963, it has grown to be the fifth largest in the world – the BDO network now has 629 offices in 111 countries, with more than 31 500 partners and staff providing professional auditing, accounting, tax and consulting services on every continent.

BDO's special skills lie in applying its local knowledge, experience and understanding of the international context to provide an integrated global service. In BDO, common operating and quality control procedures are not a constraint on innovation and independence of thought, but the starting point. It is a vigorous organisation committed to total client service.

BDO's reputation derives from consistently offering imaginative and objective advice within the client's time constraints. BDO Member Firms take pride in their clients' success and their relationships with them. It is a personal relationship that combines the benefits of professional knowledge, integrity and an entrepreneurial approach, with an understanding of a client's business and an ability to communicate effectively. This ensures the highest-quality objective professional service, tailored to meet the individual needs of every client, whether they be governments, multinational companies, national or local businesses, or private individuals.

Doing Business in Germany 2008 has been written by BDO Deutsche Warentreuhand, the German Member Firm of BDO. Its contact details may be found on page 63 of this publication.

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General information

Geography

The Federal Republic of Germany (*Bundesrepublik Deutschland*), called Germany for the purposes of this booklet, is situated in the heart of Europe, covering an area of some 357 000 km^2. It borders the Netherlands, Belgium, Luxembourg and France to the west, Switzerland and Austria to the south, Denmark to the north and Poland and the Czech Republic to the east.

The federal capital is Berlin, which has a population of 3.416 million. Other major cities include Hamburg (1.769 million), Munich (*München*) (1.295 million), Cologne (*Köln*) (991 000) and Frankfurt-am-Main (668 000).

Government and law

Germany is a federal parliamentary republic. At the federal level, legislative power is exercised by the bicameral parliament, which consists of the *Bundestag* and the *Bundesrat*. The *Bundestag* currently has 614 members, elected by a mixed system of simple-majority and proportional representation. The upper house, the *Bundesrat*, consists of representatives of the sixteen federal States (*Bundesländer*). Executive power is exercised by the federal government, presided over by the federal Chancellor (*Bundeskanzler*), which must enjoy a majority in the *Bundestag*. Following the general election of 2005, the government is formed by a coalition of the two largest parties – the Christian Democrat/Christian Social Union (CDU/CSU) and the German Social Democratic Party (SPD). The Chancellor is Mrs Angela Merkel (CDU/CSU). The Head of State is the federal President, indirectly elected by parliamentarians. That office is currently occupied by Dr Horst Köhler (CDU/CSU).

A good deal of power rests with the *Bundesländer*. In alphabetical order, they are Baden-Württemberg, Bavaria, Berlin, Brandenburg, Bremen, Hamburg, Hesse, Lower Saxony, Mecklenburg-Western Pomerania, North Rhine-Westphalia, Rhineland-Palatinate, Saarland, Saxony, Saxony-Anhalt, Schleswig-Holstein and Thuringia.

Although the country is decentralised, federal law predominates, and the public, civil, commercial and tax areas and business practices are almost the same everywhere.

Population and language

Germany has a population of over 82 million, and is the most populous Member State of the European Union. The official language is German.

Currency

Germany has adopted the single European currency, the euro (EUR), which replaced the Deutschemark in 2002. The euro is divided into 100 cents. At the time of going to press (early November 2008), the euro to US dollar exchange rate was EUR 1 = USD 1.2790.

Weights, measures and temperature

Germany uses the metric system of weights and measures, and the Celsius scale of temperature.

Time zone

Germany uses Central European Time, which is one hour ahead of Greenwich Mean Time (GMT). When daylight saving is in operation, clocks are two hours ahead of GMT.

Economy

Germany operates as a free and open market with minimal bureaucratic restrictions on the movement of goods, funds and people, and the emphasis is firmly on private enterprise. With Germany's status as a founding member of the European Community and participant in the ensuing treaties, such as the Maastricht Treaty and the European Economic and Monetary

Union (EMU), its economy has close connections to other European countries. Due to German reunification, strong ties to eastern European markets and opportunities exist. The reasons for making Germany a European headquarters location are numerous, and include the availability of highly qualified staff with good skills in speaking and writing the English language.

Business entities

German law permits various forms of business organisation. The main forms, apart from businesses owned by the Government, are:

Companies

- Joint-stock company (*Aktiengesellschaft* - AG)
- Limited-liability company (*Gesellschaft mit beschränkter Haftung* - GmbH)
- European company (*Europäische* AG - *Societas Europaea* SE)

Partnerships and other

- General partnership (*Offene Handelsgesellschaft* - OHG)
- Limited partnership (*Kommanditgesellschaft* - KG)
- Partnership limited by shares (*Kommanditgesellschaft auf Aktien* - KGaA)
- Civil-law partnership (*Gesellschaft des bürgerlichen Rechts* - BGB-*Gesellschaft*)
- Silent partnership (*Stille Gesellschaft*).
- Partnership under the Partnership Act (*Partnerschaftsgesellschaft*)
- European Economic Interest Grouping (*Europäische Wirtschaftliche Interessenvereinigung*)
- Branch of a foreign enterprise (*Niederlassung einer ausländischen Gesellschaft*)
- Sole proprietorship (*Einzelunternehmen*)

The most common form of organisation for a new business starting in Germany is the limited-liability company (GmbH). The main forms of organisation that should be considered by a foreign investor wishing to acquire an existing business, or having to decide on the legal form for a new enterprise, are dealt with in more detail below.

Joint-stock company

The joint-stock company is usually used when funds are to be raised from the general public, for example, on the German stock markets. It is an incorporated business entity. All details as to the rights and duties of joint-stock companies and ir shareholders are governed by the Joint-Stock Companies Act (*Aktiengesetz* - AktG).

Capital

The minimum share capital of an AG is EUR 50 000 (USD 63 950), which must be fully subscribed and of which at least 25% must be paid up at the time of incorporation. Capital contributions in kind are possible but must be fully paid up and their value is subject to examination by the registrar. Shares must have a minimum par value of EUR 1. Shares may also be issued without a par value but the value allocable to each share must be at least EUR 1.

If shares have been issued at above par value, the premium has to be transferred to a legal reserve account, to which 5% of annual post-tax income must also be transferred until that account equals 10% of the share capital.

Organisation

The shareholders exercise their rights in general meetings. With a few exceptions (such as an increase of share capital, mergers and liquidation) resolutions require a simple majority of votes for approval. In particular, the general meeting appoints the supervisory board, approves the amount of dividend distributions, any increases or decreases of share capital and any amendments of the Articles of Association.

The appointment of a supervisory board (*Aufsichtsrat*) is mandatory, and its make-up is prescribed by law. It must consist of at least three members but its size varies up to a maximum of twenty-one members, depending on the amount of issued share capital. One-third of the members must be employees and are separately elected by the employees, if the company has at least 500 employees. Special rules apply for joint-stock companies with more than 2000 employees and for the iron and steel industry (half of the members have to be employees).

The supervisory board appoints, removes, supervises and advises the management board, appoints the auditor, receives the auditor's report and the report of the management board, and reports to the general meeting on the result of its review of these reports.

The members of the executive board (*Verwaltungsrat*) legally represent the joint-stock company and are responsible for its management. The law puts most decisions in the hands of the management board.

Limited-liability company

A limited-liability company also enjoys a legal identity of its own. Its shareholders are not personally liable for the debts incurred by the company. In contrast to those for the joint-stock company, the formalities required to establish and operate a limited-liability company are much less comprehensive and expensive. A limited-liability company can also be founded by a single individual or another company, which is one of the reasons why it is the most popular form of business organisation when starting a new business in Germany. The Limited-Liability Companies Act (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung* - GmbHG) prescribes all of the relevant requirements for establishing a limited-liability company.

A limited-liability company's legal existence begins when it is entered in the local commercial register. It is possible for a limited-liability company to start operations before entry in the commercial register but after the articles of association are signed, although the shareholders and / or general managers who acted on behalf of the company are fully personally liable until the entry in the commercial register is made. It is common to buy already existing 'shelf companies', which have not yet started business.

Capital

The minimum share capital is EUR 25 000 (USD 31 975). It must be fully subscribed on the company's formation. Each shareholder must pay in at least 25% of his subscription but in total a minimum of EUR 12 500 (USD 15 975) must be paid up prior to registration. Capital contributions in kind are subject to examination by the trade register to ensure that the assets contributed are fairly valued. Share certificates are not required by law. Transfers of shares, for example by purchase agreement, must be executed before a notary public and must be brought to the attention of the company and the trade register.

The German Government has approved a draft bill that will lead to significant changes in GmbH law. It is intended to reduce the minimum capital to EUR 10 000 (USD 12 800), of which at least EUR 5000 (USD 6400) has to be paid up upon registration. Starting with a lower capital would also be possible if the company name is supplemented by the words: *Unternehmergesellschaft* (*haftungsbeschränkt*) or UG (*haftungsbeschränkt*), which indicates that the company does not yet have the minimum capital. In that case the company would have to retain 25% of its annual profits until the minimum capital is accumulated. Furthermore, a deregulation of the capital maintenance rules is intended, which should ease the repayment of shareholder loans including the agreements of cash-pooling systems. The draft bill is expected to become law at the end of 2008.

Organisation

The shareholders exercise their rights at shareholders' meetings. Shareholders' resolutions require a simple majority of votes for approval unless the articles of association or the law require a qualified majority. For instance the law prescribes a 75% majority for a change of the articles of association. The shareholders' meeting decides all matters outside the ordinary course of business, in addition to all those matters ascribed to it by law or in the articles of association.

A limited-liability company is legally represented and managed by one or more managing directors (*Geschäftsführer*). Managing directors are appointed and removed by the shareholders' meeting. The rights and duties of a managing director ensue from the law, the articles of association and his or her employment contract. It is possible to limit the power of the managing director(s) or to give advice on single issues.

The managing directors are personally responsible for failures of their company and can be sued – for example for unpaid taxes or creditor losses in case of bankruptcy – if they violate their duties.

A supervisory board is required by law only in cases where the limited-liability company employs more than 500 individuals. In that event, one-third of the supervisory board members must be elected by the employees. If there are 500 employees or fewer, it is possible, however, to provide for a voluntary supervisory board in the articles of association. Other rules apply in the case of large limited-liability companies with 2000 employees or more and in the iron and steel industry.

European company (Societas Europaea - SE)

The aim of the European company is to ease the formation of holding companies or subsidiaries by companies in different EU Member States without the legal and practical problems that may arise from the different legal systems of the Member States.

An SE may be formed by

- merger
- formation of a holding SE
- formation of a subsidiary SE
- conversion of an existing public limited liability company into an SE

Capital

The minimum subscribed share capital is EUR 120 000 (USD 153 475). If there are laws of a Member State requiring a greater subscribed share capital for companies carrying on certain types of activity, these laws apply to SEs with a registered office in that Member State. Furthermore, the share capital, its maintenance and changes thereto, together with its shares, bonds and other similar securities are governed by the provisions thaty would apply to a public limited-liability company with a registered office in the Member State in which the SE is registered. This means that in Germany the German Joint-Stock Companies Act must be applied.

Organisation

The shareholders exercise their rights in general meetings. With a few exceptions regulated in the provisions on the statutes for an SE, (Amendment of the SE's statutes) or in the Member State in which the SE's registered office is situated, (e.g. Germany: increase of share capital, mergers or liquidation) resolutions require a simple majority of votes for approval.

The SE has to decide between either a supervisory board and a management board (two-tier system, e.g. Germany) or an administrative board (one-tier system, e.g. United Kingdom).

General and limited partnerships (OHG and KG)

The main feature of a general partnership is that each of the general partners assumes unlimited personal liability for the firm's liabilities.

A limited partnership has at least one general partner who is subject to unlimited liability and one or more limited partners. The limited partners' liability is restricted to their share of the partnership capital. The rights and duties of a partner are regulated in the German Commercial Code (*Handelsgesetzbuch*) and in the partnership agreement. A partnership does not have its own legal identity but may conclude agreements and may sue or be sued under its firm name. It comes into existence when the partnership agreement is concluded and operations start. It must be registered with the local commercial register. There are no legal requirements as to the minimum amount of capital or the maximum number of partners. Unless stipulated otherwise in the partnership agreement, each general partner is entitled to take part in the management of the enterprise whereas limited partners are excluded from the management by law. Limited partners may, however, be given a mandate to manage by contract.

A combination of a limited partnership and a limited-liability company is the so-called GmbH & Co. KG. This type of organisation is a limited partnership where the general partner is a limited-liability company. In this case only the GmbH is fully liable for the debts of the partnership, whereas the limited partners are responsible only to the extent of their contribution to the partnership capital.

In general, profits and losses are shared in the proportion of capital accounts. However, limited partners take part in losses only up to an amount that equals their agreed capital share. Partnerships are subject to trade tax on income (see Chapter 4) but are not subject to other income taxation, whereas the partners are. Thus earnings may be subject to corporate tax or personal income tax, depending on whether the partner is an entity or an individual.

Civil-law partnerships, silent partnerships and sole proprietorships

A civil-law partnership is an association of individuals or enterprises to achieve a joint contractual purpose; a sole proprietorship is the business of one individual. In the case of a silent partnership, the silent partner contributes money, assets or services to an enterprise in return for a share of the enterprise's profits and, possibly, losses.

Branch of a foreign enterprise

An alternative approach for the foreign investor is to open a branch operation, rather than to set up a separate German company.

A branch operation is simply a part of the foreign business enterprise in whatever legal form that enterprise carries on its operations. Accordingly there are no specific German legal requirements for establishing and operating a branch of a foreign enterprise in Germany (exceptions apply e.g. for bank or insurance companies). On the condition that the branch operation exercise essentially the same activities in Germany as the head office abroad, it may be entered in the German local commercial register as a registered branch (*Zweigniederlassung*) by filing the foreign incorporation documents. Representative offices not engaged in a trade or business are not regarded as branches, although for taxation purposes the definition of a permanent establishment in an applicable tax treaty must be considered.

Although no formal capital is required by law, the tax authorities demand an adequate 'endowed' branch capital corresponding to the functions of the branch. In the case of a registered branch the head office has to appoint a branch manager as legal representative. In other cases the branch is represented by the legal representatives of the foreign company, unless a proxy is given to a supervising person in order to carry out the day-to-day business of the branch.

Employment and labour relations

Availability of labour

The German labour force is highly skilled, disciplined and qualified. Because of relatively high unemployment – especially in the new Eastern German states – demand for skilled and specialised workers and employees can normally be satisfied.

Unskilled and semi-skilled workers may be recruited from the official employment office. White-collar workers, highly skilled workers and middle management are usually recruited through newspaper and internet advertising and/or with the help of executive-search consultants.

Nationals of EU Member States may move freely within Germany and do not require work permits. The inflow of foreign workers from non-EU countries depends on bilateral treaties and on German market conditions. As a general rule it is not a problem to temporarily assign employees from foreign companies located in industrialised countries to work in German group companies.

Employment relations

Labour regulations

Employee/employer relations are comprehensively regulated by the law, by agreements between trade unions and employers' umbrella organisations, by agreements between the management board and the workers council and by individual employment contracts. Disputes between employee and employer are subject to the jurisdiction of employment courts. In limited-liability companies with at least 500 employees, and in joint-stock companies with more than 2000 employees, a system of participation or of codetermination applies by law. Additionally according to the Works Council Constitution Act (*Betriebsverfassungsgesetz*), staff members have the right to implement a workers' council (*Betriebsrat*) in companies with more than five eligible employees.

The value of such requirements depends, one could say, differs from the viewpoint of management, unions and individual employees. Nevertheless, the influence of the workers' council should not be overlooked, and it must be provided with information before decisions affecting employees or workers are implemented. Consultations among management and union leaders are common since this can prevent problems.

Wages and salaries

The average monthly gross earnings of employees in industry, trade, bank and insurance in 2006 was about EUR 3960 (USD 6175) in the western states of Germany. At all levels of employment, there are certain disparities between towns, counties and States as well as between areas with more or less serious unemployment problems. In eastern Germany, wages are currently slightly lower than comparable western levels. These discrepancies are expected to vanish during the next few years.

A new trend in employment contracts allows wages to vary depending on the region, and opting-out clauses for companies in financial difficulties are now available in most agreements with the trade unions.

Compulsory fringe benefits include employers' contributions to the state social security schemes, maternity benefits, insurance coverage for employees for injury suffered during the course of employment, travel to and from the place of business, and sick pay for a period of up to six weeks.

In addition to the benefits that individuals receive from the social security system, many German employers provide retirement and/or disability benefits to employees, and sometimes to widows and orphans. Such obligations are often fulfilled by separate legal entities such as pension funds or relief funds, which are financed by the employer. In other cases employers set up provisions on their own balance sheets to cover estimated future liabilities for pensions. In this case the employer is required to pay insurance premiums to a fund set up to give protection to employees if the employer is not able to meet its obligations.

The working week is typically 37 to 40 hours long. Depending on age or period of employment, four to six weeks' paid holiday leave is customary in most industries.

Termination of employment

The termination of employment is dealt with in the Civil Code and the Termination of Employment Act. Under the latter, an employee may be dismissed only for valid reasons, such as the employee's misconduct or an unavoidable reduction of the enterprise's labour force requirements (redundancy). If the employee feels that the dismissal is unjustified, the matter can be taken to an employment court, which may either confirm valid reasons for termination, award a redundancy payment of up to one year's salary, or confirm the continuation of the employment. The German Government intends to relax dismissal protection for employees under two years of seniority in the current legislative period.

The period of notice of termination prescribed by law depends on the employee's age and length of service, but in principle employers and employees may terminate contracts of employment by giving four weeks' notice to the 15th or the end of a month. If a workers' council exists, it has to be consulted prior to termination of a contract by the employer.

Work permits

Citizens of the European Union, the European Economic Area and Switzerland may work in Germany without any restrictions. Non-self-employed workers from the newer EU Member States such as Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia fall under transitional rules. Other foreigners have to apply for a work permit before they can work in Germany.

As a consequence of the introduction of a process known as 'one-stop government' foreigners no longer have to apply for a separate work permit at the local job centre (A*rbeitsamt*) but will receive their work permit as part of the visa itself. Therefore the visa will indicate whether the foreigner is allowed to work in Germany and if so, to what extent work will be permitted.

2. Finance and investment

Regulation of business

Any company doing business in Germany is subject to federal and State laws. A number of federal and State ministries are responsible for the regulation of industry and commerce. These include the Ministries of Finance, Economic Affairs, Justice, Social Affairs and Employment and Environmental Protection.

Requirements for doing business and trade

The German constitution and the Commercial Code enable every German citizen to carry out a trade or business in Germany wherever he or she likes. This principle, however, is limited by the requirement to obtain a trade permit from the local trade office, which will be granted in general if the businessman or woman applying is at least 18 years of age, has full legal capacity and is an EU resident.

Before starting a normal trade or business all the general conditions have to be met. For handicraft and craft businesses additional proof of qualification is required. There are also some trades that may only be carried out after a special licence has been granted.

A foreign-owned business or trade may be set up in any part of the country. It will be subject to the same rights and restrictions that apply to locally owned businesses.

Price controls

Under the Price Control Act the federal Government may establish price ceilings. At the moment, however, there are only a few items that are subject to price controls, such as certain medicines.

Monopolistic and anti-competitive practices

Germany provides for a basically competitive business environment.

Regulations ensuring a competitive environment are set out in the Unfair Competition Act (*Gesetz gegen unlauteren Wettbewerb* - UWG). The main provisions are:

- Information on goods must be true, correct and not misleading
- Comparative advertising is only allowed subject to certain restrictions
- Unsolicited e-mails, telephone calls, or faxes to potential customers are not allowed

Other regulations ensuring a competitive environment are set out in the Restraints on Competition Act (*Gesetz gegen Wettbewerbsbeschränkungen* – GWB). The Federal Cartel Office (*Bundeskartellamt*), for example, may prohibit agreements between companies resulting in a restraint of trade. This office may also intervene in cases of concerted conduct or conscious parallelism (*abgestimmtes Verhalten*) between firms, and in cases of discrimination or boycotts against competitors.

European anti-monopoly law (especially Articles 81 and 82 of the EC Treaty) is directly applicable in Germany. Article 81 of the EC Treaty prohibits all agreements between two or more firms which restrict competition within the Single Market. This provision covers a wide variety of behaviour. Article 82 of the EC Treaty prohibits any abuse of a dominant position within the Single Market.

The legislation of the European Community in the area of fair trade practices and anti-monopoly laws must be observed, along with the European anti-monopoly regulations and the extensive case law on these issues. This is enforced by the EU Commission's Competition Directorate, which is allowed to impose fines on the companies which do not comply with these regulations.

Mergers

In general, companies are free to merge in Germany. There are, however, restrictions set out in the Restraints on Competition Act.

Mergers have to be reported to the Federal Cartel Office if at least one of the firms in the merger meets certain size and market-share criteria. If a market-dominating position would be reached or strengthened, the office may prohibit the merger or acquisition, or even require a segregation of the companies involved. The ruling of the Federal Cartel Office can be overruled by the Federal Minister of Economic Affairs. In such a case, special permission for a merger can be issued by the Minister of Economic Affairs, if the advantages to the German economy as a whole would be more important than the restraint of trade.

If a merger affects competition in other EU Member States and the combined business exceeds specified thresholds in terms of global and European sales, the proposed merger must be brought to the European Commission, which must examine it. The EU Commission must approve or disallow the merger. Below these thresholds, the national competition authorities in the EU Member States may review the merger. If the EU authorities approve a merger, Germany cannot enforce its domestic anti-monopoly law unless the EU authorities delegate jurisdiction over the case to the German Federal Cartel Office.

Consumer and environmental protection

Consumer and environmental protection is very important in Germany. The main areas of consumer protection include product liability, labelling of products, advertising, guarantees and warranties, consumer rights, and duties with respect to instalment-sales contracts. According to civil law, certain clauses in the general conditions of commercial enterprises are deemed to be unfair if they are applied to contracts between commercial enterprises and consumers. The supply of certain goods may require the prior admission by state bodies (e.g. drugs) or may be subject to control (e.g. food products).

Matters of environmental protection have become more and more important during the past few years. The legislation in this field covers the protection of the quality of water and air, and is also aimed at the reduction of noise levels. Special industrial plants, for example, which could endanger the quality of water or air, or which can produce too much noise, may only be installed after a special licence has been granted. All such plants and business operations are subject to supervision at the State (*Land*) level, and in some cases to federal supervision. Companies and managers operating such industrial plants can be liable for damages caused to the environment. In some cases the law also provides for fines and penalties. Foreign investors intending to operate such plants need to make themselves familiar with these strict German laws for environmental protection.

Import and export controls

In general Germany enjoys free foreign trade, according to which imports and exports are usually not restricted. Certain laws and governmental directives impose special restrictions, however, particularly on sensitive goods such as arms or nuclear equipment.

Germany imposes no import restrictions or licensing requirements, except in the case of a few sensitive products such as wildlife products of protected species. German requirements relating to food and drug labelling, packaging, trademarks etc. may sometimes constitute import barriers.

Since Germany is a member of the European Union, special import and export regulations determined by the EU Commission are also applicable for trade to and from Germany. Within the EU customs duties have been abolished. The EU member countries apply a common external tariff to imports from outside the European Union. However, the European Union has entered into numerous preferential trade agreements with other countries by which import duties are considerably reduced or abolished. Germany is also a member of the World Trade Organisation (WTO) and the Organisation for Economic Cooperation and Development (OECD).

Exchange controls

The euro is freely convertible into foreign currencies. The federal Government can impose, under certain conditions, restrictions on foreign money or loan capital coming into Germany by requiring a cash deposit with the Federal Central Bank (*Deutsche Bundesbank*), if this is not prohibited by existing EU regulations. At present there are no such restrictions in force.

There are, however, extensive reporting requirements for statistical purposes with respect to the following:

- purchase and sale of a participation in foreign companies and branches by residents,
- purchase and sale of a participation in domestic companies and branches by non-residents and
- payments, liabilities and claims between residents and non-residents.

Banking and local finance

Banking system

The German central bank, *Deutsche Bundesbank*, along with the other central banks in the eurozone shares responsibility with the European Central Bank (ECB) for fulfilling the eurozone's monetary-policy tasks. Deutsche Bundesbank is involved in maintaining price stability in the euro area. Deutsche Bundesbank is also responsible for managing the currency supply in Germany and ensuring the stability of payment and clearing systems. It is independent of government and maintains nine regional offices (*Landeszentralbanken*).

The banking system is well developed and is one of the most dynamic sectors in the German economy. Many of the major banks have a large number of offices throughout the country, good international relations, and subsidiaries, branches or representative offices in many foreign countries.

Frankfurt am Main is the financial centre of Germany and houses the headquarters of the European Central Bank. More than 300 domestic and foreign banks are represented in Frankfurt by headquarters, subsidiaries, branches or representative offices.

Germany has a universal banking system, which means that German banks are typically engaged in the full scale of banking activities, providing a complete range of services. Recent developments have led to the founding of direct (internet) banks without expensive offices, but with telephone and computer access. The most important types of banks are the big private banks that operate nationwide (e.g. Deutsche Bank, HypoVereinsbank, Dresdner Bank, Commerzbank), State-dependent banks with special knowledge and a function for setting up businesses, and savings banks.

Another recent development is the increased competition between banks and insurance companies. As banks become engaged in the insurance business, some insurers want to provide a full range of financial services and are, therefore, engaged in banking business either in the form of cooperation with, or shareholdings in banks.

Banking secrecy

According to the contracts between banks and their customers, banks are not allowed to disclose or make use of secrets which have been entrusted or made accessible to them by their customers. Exceptions are limited to cases where criminal proceedings have been instituted. German banking secrecy also applies in relation to the tax authorities. The tax authorities can, however, request information from a German bank in relation to a specific person who is subject to German tax liability, if criminal proceedings have already been instituted because of presumed tax fraud, or in cases in which that person did not provide the requested information to the tax authorities himself. As from 1 April 2005, the German Fiscal Code (*Abgabenordnung*) was amended with regard to banking secrecy. As from that date, the tax authorities may automatically access data from data files that banks must provide. These data concern account and deposit numbers, the date of opening and closure of accounts and the name of the holder (so called permanent data) but not account balances and account movements.

Banking regulations and banking supervision

Banking in Germany (domestic and foreign banks) is extensively regulated under the Banking Act (*Kreditwesengesetz* – KWG), which aims to protect customers. The enforcement of the regulations contained in the Banking Act is closely supervised by the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – BaFin) in Bonn.

Equity markets

Equity markets are well developed in Germany. The Frankfurt Stock Exchange (FWB – *Frankfurter Wertpapierbörse*) is one of the world's largest trading centres for securities. Besides traditional floor trading, it has, in Xetra, one of the leading electronic platforms in the world. The Frankfurt Stock Exchange is an international trading centre; about 140 of its 300 or so market participants come from abroad. Besides the Frankfurt Stock Exchange, regional stock exchanges operate in Berlin, Bremen, Hannover, Hamburg, Düsseldorf, Munich and Stuttgart. Aside from a trading platform for company shares from the respective region, the other exchanges have predominantly specialised in specialty areas.

Going public

Listing on a German stock exchange

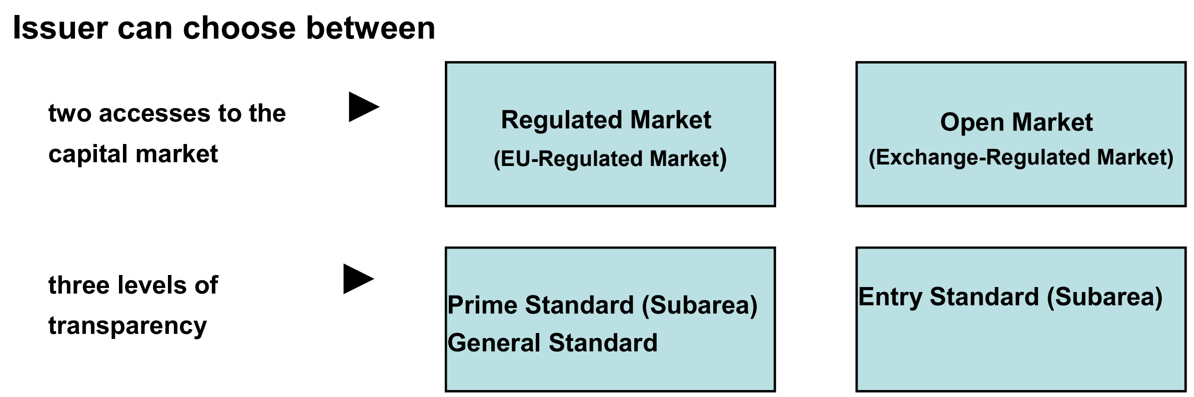
Going public has become a normal financing option for larger companies.

When it comes to a listing in Germany, companies can choose between the two legal market segments, the regulated and the open market. The regulated market is an EU-regulated market, i.e. the requirements for admission and the necessary degree of transparency are governed by provisions of the European Union. The open and regulated markets differ primarily in the strictness of their admission requirements. Companies listed on the regulated market meet the highest European transparency requirements. The open market is a segment under private law regulated by the respective stock exchange. Here, the requirements for trade admission and the sequencing obligations are significantly less strict. Aside from German securities, trading in the open market predominantly includes foreign shares, bonds of German and foreign issuers, certificates and warrants.

Market segments

These are illustrated schematically in Figure 1.

Figure 1



The regulated market

The Regulated Market is a market organised under the terms of the German Securities Trading Act (*Wertspapierhandelsgesetz* – WpHG). In detail, the legal foundations for admission are defined in the Stock Exchange Act (*Börsengesetz*), the Listing Ordinance (*Börsenzulassungsverordnung*), the Prospectus Act (*Wertpapierprospektgesetz*) and the Stock Exchange Code (*Börsenordnung*). For admission of a security to the regulated market, the issuer and a credit institution or financial-services provider (underwriting member bank) submit the application and a listing prospectus to the Admissions Office. These provide information on the character and volume of the securities that are to be introduced. The issuer and the credit institution are responsible for the accuracy of the information provided. At the expense of the applicants, the Admissions Office needs to publish the application for listing in the Federal Gazette, the compulsory stock exchange gazette named in the application and also publish it by way of a stock-exchange announcement.

Fundamental criteria for initial registration of securities are as follows:

- the issuer must have existed for at least three years as a company
- the anticipated market value of the securities that are to be admitted or – if an estimate is not possible the company's equity – amounts to at least EUR 1.25 million (USD 1.599 million)
- the number of shares issued amounts to at least 10 000 in the case of shares without a par value
- shares available to non-institutional investors must be at least 25% of the shares issued
- the admission document is a listing admission prospectus including the information on the actual and legal situation essential for the rating of both the issuer and securities The listing admission prospectus must contain the financial statements, and cashflow statements of the past three business years as well as the previous business year's notes to the financial statement and the directors' report.
- The language of publication must be German, although English is admissible for foreign issuers
- decisions with respect to admission are made by the management board of the respective stock exchange

An issuer may submit applications for listing to more than one domestic stock exchange at the same time.

Fundamental ongoing reporting obligations are:

- disclosure of financial statements
- publication of an interim report for the first six months of the business year
- *ad hoc* disclosure under section 15 WpHG
- duty of notification under section 21 WpHG

The open market

The basis for admission of securities to the open market is provided by the open-market directives of the respective stock exchange. There are few formal admission requirements and in general, no ongoing reporting obligations for the issuer. In the case of the Frankfurt Stock Exchange, the fundamental admission criteria are as follows:

- the admission application must include a precise description of the security that is to be admitted while it must also include information on where prices for this security have already been determined, i.e. identify the relevant domestic or foreign organised market. If the securities are not traded in any organised market, the applicant must present more detailed information concerning the issuer in terms of either a prospectus approved by the national supervisory body or a synopsis that allows for an appropriate rating.
- the admission application of an issuer must be filed in writing by a company admitted to the Frankfurt Stock Exchange.

- in written form and without delay, the applicant must inform the *Deutsche Börse* AG about material circumstances with regard to the admitted securities or the issuer.
- the decision-making body concerning the admission is the *Deutsche Börse* AG as the responsible body for the open market.
- the language of publication must be German, or English together with a German translation

Subsidiary areas

Within these market segments, some trading floors have different subsidiary areas. At the Frankfurt Stock Exchange, these are the General Standard, Prime Standard and Entry Standard. Stuttgart and Munich have the subsidiary areas 'Gate-M' and 'M:access', which are intended to address medium-sized companies in particular.

While the General Standard ultimately contains all of the companies listed on the regulated market of the Frankfurt Stock Exchange, the Prime Standard is a subsidiary area of the EU-regulated market segment, where international transparency standards must be met. These are, in detail:

- quarterly reporting in German and English
- application of international accounting standards (IFRS/IAS or US GAAP)
- publication of a company calendar
- organisation of at least one analyst conference a year and
- *ad hoc* disclosure also in English.

Admission to the Prime Standard is a basic requirement for being accepted into the selection indices DAX®, MDAX®, TecDAX®and SDAX®.

Although the Entry Standard is based on the open market, it goes beyond the latter's requirements. Companies must publish the audited group financial statements and the group directors' report on their company website within six months of the end of the reporting period at the latest. The same applies to the publication of an interim report. The company profile and the company calendar must be updated annually. In addition, company news that might influence the stock market price must be published immediately. It is also compulsory to conclude a contract with a Deutsche Börse Listing partner.

Accounting and audit requirements

Statutory requirements

While IFRS or US GAAP focus on investors (provision of information to the investors), German accounting principles still focus on the needs of creditors (protection of the creditors' interests). They are codified in Part Three of the Commercial Code (*Handelsgesetzbuch*), where most of the EU Directives on accounting are also incorporated. The first Chapter of Part Three contains provisions for all legal forms and types of businesses relating to bookkeeping rules, the preparation of financial statements and the valuation of assets and liabilities.

Chapter Two of Part Three contains specific provisions relating to the form and content of financial statements, consolidated financial statements and statutory audit and disclosure requirements. These requirements apply to companies, such as joint-stock companies (AG) and limited-liability companies (GmbH), to partnerships limited by shares (KGaA) and to certain general partnerships (OHG) and limited partnerships (KG) in which there is no individual as general partner.

In addition, some specific requirements can be found in special laws and for certain industries, for example in the Joint-Stock Company Act, The Limited-Liability Company Act, the Banking Act (KWG) and the Insurance Supervisory Act (*Versicherungsaufsichtsgesetz* – VAG).

In principle, tax accounting is based on commercial accounting. There may be deviations resulting from tax law. However, tax law sometimes requires that methods used for tax purposes (e.g. accelerated depreciation) also be considered in commercial accounting.

At the present time, a revised version of German GAAP has been drafted by the Ministry of Justice. It is expected that these revised accounting principles will be enacted by the end of 2008. Commercial accounting will therefore have to comply with these revised accounting principles starting with this financial year. The intention is to retain the simplicity of these principles while establishing German accounting principles as a competitive alternative to international standards. This revision will introduce the well-known true and fair view to German GAAP.

Accounting requirements for all businesses

Preparation of financial statements

All businesses, with the exception of certain small traders, are required to keep books and records in accordance with generally accepted accounting principles (G*rundsätze ordnungsmässiger Buchführung* – GOB) and to prepare financial statements, including a balance sheet and an income statement. Companies, partnerships limited by shares and certain general and limited partnerships are also required to prepare notes to the financial statements. The books and records as well as the financial statements must be set up in such a way that an independent expert can obtain an overview of the assets and liabilities and an insight into the operations of the business within a reasonable time. Books and records must be kept in a living language and financial statements must be prepared in the German language using the euro as the unit of account. Entries into the books must be made in a complete, correct, timely and orderly manner. The financial statements must be prepared within a reasonable time after the end of the accounting year. The accounting year is specified in the statutes of the company. It can comprise less than 12 months in the case of start-ups, but never be more than 12 months.

Contents of financial statements

In general, all assets, liabilities, reserves, revenues and expenses must be recorded completely. Some items to be included in financial statements require specific treatment:

- intangible assets acquired for a consideration must be capitalised
- purchased goodwill can be capitalised. Any amount capitalised must be written down over a four-year period, or in accordance with its expected useful life. However, income tax law requires capitalisation of purchased goodwill and a straight-line amortisation over a 15-year period
- full pension obligations resulting from direct pension promises must be accrued
- necessary repairs and maintenance carried out within the first three months of the following accounting year must be accrued
- guarantee/warranty expenses incurred without contractual obligation must be accrued
- necessary industrial reclamation costs must be accrued, in so far as the expenses are incurred during the following accounting year

According to the current draft revision, purchased goodwill, for example, has to be capitalised and self-created intangible assets have to be valued at their manufacturing costs. But research costs may not be included. Apart from that accruals for necessary repairs and maintenance cannot any longer be made where the necessary repairs and maintenance are performed between four and twelve months after the end of the business year.

Inventory methods

Inventories of goods must be counted, measured and recorded in the books at the balance-sheet date. Permanent inventory is acceptable if certain requirements are met. For movable fixed assets a physical inventory must be performed at each balance-sheet date, unless permanent records are maintained.

Valuation principles for valuation of assets and liabilities

The major valuation principles are as follows:

- the values included in the opening balance sheet of one accounting year must agree with those of the closing balance sheet of the preceding accounting year
- the valuation should assume the going-concern principle, if not prohibited *de facto* or *de iure*
- assets and liabilities must be valued at the balance-sheet date on an item-by-item basis
- values must be determined prudently, all foreseeable risks and losses that have arisen up to the balance-sheet date must be taken into account, even if these become known only between the balance-sheet date and the date on which the financial statements are prepared. Profits may only be taken into account if they are realised before the balance-sheet date
- income and expenses of the accounting year must be shown in the income statement, regardless of when they are received or paid
- the valuation methods applied in the preceding financial statements should be retained.

Fixed assets have to be valued at their purchase price or manufacturing cost and depreciated over their useful lives according to generally accepted depreciation methods. An extraordinary depreciation charge is required in the case of a permanent diminution in value, or to adjust to a lower value for income tax purposes. An extraordinary depreciation charge is recaptured up to historical cost should the value increase again.

Current assets are to be valued at the lower of cost and market value, or a lower value permissible for income tax purposes. Recapture up to historical cost is necessary in cases of an increase in value. Share capital must be stated at par value. Liabilities are to be valued at the repayment amount. For tax purposes, non-interest-bearing liabilities must be shown at their discounted net present value. Accruals must be set up at amounts deemed necessary according to reasonable business judgement.

The valuation of accruals in particular will change after the current revision to accounting principles. According to the new draft accounting principles, accruals with a term of more than five years have to be discounted. Apart from that the valuation will include any future price and cost increase. By means of this balance-sheet values will come to reflect a true and fair view.

Shareholder loans and capital contributions

Until now a shareholder loan could be reclassified as subordinated when it was granted at a time when a prudent manager would have contributed equity. The rules about shareholder loans (hitherto sections 32a, 32b GmbHG) are now contained in the Insolvency Code (*Insolvenzordnung*).

Retention of documents and retention period

All businesses are obliged to retain books of account, inventories, opening balance sheets, financial statements, directors' reports as well as descriptions of procedures and other organisational matters aiding comprehension of the foregoing, correspondence received, copies of outgoing correspondence and accounting documents for ten years.

Accounting, audit and disclosure requirements for corporations and certain partnerships

Categorisation of companies and certain partnerships

For accounting, audit and disclosure requirements, companies and certain partnerships are classified as small companies, medium-sized companies or large companies, depending on three criteria: the balance-sheet totals, the turnover and the annual average number of staff employed. The current thresholds are as shown in Table 1.

Table 1

	Small company	**Medium-sized company**	**Large company**
Balance-sheet total	≤ EUR 4.015 m	≤ EUR 16.060 m	> EUR 16.060 m
Turnover	≤ EUR 8.030 m	≤ EUR 32.120 m	> EUR 32.120 m
Average number of staff employed	≤ 50	≤ 250	> 250
Period allowed for preparation of financial statements	6 months	3 months	3 months
Annual audit	No audit requirement	Audit requirement	Audit requirement
Disclosure	Reduced disclosures vis à vis Commercial Register	Commercial Register publicity	Commercial Register publicity

The revised German Commercial Code will have the thresholds shown in Table 2:

Table 2

Proposed law changes[1]	**Small company**	**Medium-sized company**	**Large company**
Balance-sheet total	≤ EUR 4.840 m	≤ EUR 19.250 m	> EUR 19.250 m
Turnover	≤ EUR 9.860 m	≤ EUR 38.500 m	> EUR 38.500 m
Average number of staff employed	≤ EUR 50	≤ EUR 250	> 250
Period allowed for preparation of financial statements	6 months	3 months	3 months
Annual audit	No audit requirement	Audit requirement	Audit requirement
Disclosure	Reduced disclosures vis à vis Commercial Register	Commercial Register publicity	Commercial Register publicity

[1] applicable as of 2009.

For purposes of the above qualification, two of these three criteria must be met for two consecutive years. If the shares of a company are quoted on a stock exchange it is always presumed to be large.

Accounting requirements

Companies, partnerships limited by shares and certain general and limited partnerships where there is no individual as general partner have to fulfil all requirements set out in Part Three Chapter One of the Commercial Code – as described above – which are applicable to all businesses (that is sole proprietorships, partnerships and other non-corporate entities). In addition, they have to fulfil more specific provisions set out in the Part Three Chapter Two of the Commercial Code.

Preparation of financial statements

The managers or the board of directors of German companies and certain partnerships are obliged to prepare financial statements consisting of a balance sheet and an income statement within the first three months of the end of the accounting year. Furthermore, additional notes (*Anhang*) and a directors' report (*Lagebericht*) have to be prepared. If the company is categorised as small the period of time is extended to six months and a directors' report is not required.

Directors' report

The directors' report has to present the development and the current situation of the company in such a manner as to provide a true and fair view. The directors' report has also to deal with risks inherent in anticipated future developments. Furthermore, it has to provide information about events subsequent to the balance-sheet date, prospective developments, research and development activities and divisions of the company.

Audit requirements

The financial statements, including the notes to the financial statements and the directors' report, of medium-sized and large companies must be examined by an auditor. The audit must be of sufficient scope to determine whether the accounting regulations and additional terms of the articles of association have been observed and to detect in the ordinary course of examination major errors and violations against the abovementioned provisions. The financial statements, including the notes to the financial statements and the directors' report, have to be examined to determine whether they are in compliance with the statements of the auditor and provide a true and fair view of the net worth, the financial position and the results of the company. Furthermore the auditor has to examine whether the risks of future developments to be stated in the directors' report have been presented appropriately.

An auditor may not audit a company to which he provides certain advisory and other services. These inadmissible services comprise bookkeeping, preparing the financial statements, management and financial services, as well as certain actuarial services and evaluation services. As regards public-interest companies (capital-market companies, banks, insurance companies), auditors are barred from the audit if they provide legal and tax-advisory services that have a creative and significant influence on the net assets, financing and results of operations of the company and if they make a significant contribution towards the introduction of IT accounting systems.

Disclosure requirements

Large companies have to file and publish with the Electronic Federal Gazette (www.ebundesanzeiger.de) their financial statements together with the auditor's report. There are certain simplifications for medium-sized and for small companies as far as the publication rules are concerned. The disclosure is mandatory and violations are officially prosecuted and enforced.

Branches of foreign banks and companies situated in the EU and EEA are allowed to submit their financial statements, the directors' report and the consolidated financial statements and consolidated directors' report of their main office in English where German is not the official language at the seat of the main office.

Consolidated financial statements

The Commercial Code requires a domestic parent company and certain parent partnerships to prepare consolidated financial statements to the extent that there exists a relationship with a subsidiary enterprise of uniform control and, additionally, a participation in the form of a qualifying shareholding (normally exceeding 20% of the nominal capital). The requirement to prepare consolidated financial statements always exists – i.e. it cannot be refuted – where there is:

- a holding of the majority of the voting rights
- a controlling personal influence

- an agreement allowing for a dominant influence
- a controlling influence based on a by-law provision.

The consolidated financial statements consist of a consolidated balance sheet, a consolidated income statement and supplementary notes to the consolidated financial statements, as well as a consolidated cashflow statement and the presentation of the consolidated equity. In addition, companies are required to publish a directors' report giving a true and fair view of the development of the business and of the future prospects of the group. The accounting methods for consolidated statements include the consolidation of capital and investments in subsidiaries, the elimination of inter-company receivables and payables, the elimination of unrealised inter-company gains or losses and separate disclosure of minority interests. Companies are freed from the requirement to prepare consolidated financial statements only if certain limits of balance-sheet totals, turnover or number of employees are not exceeded.

A parent enterprise that is at the same time a subsidiary of a parent enterprise resident in another EU Member State is not obliged to prepare consolidated financial statements if consolidated financial statements (including a group directors' report) of the parent enterprise, including the audit opinion or disclaimer opinion, are published in German in accordance with the relevant rules.

A parent enterprise cannot make use of this exemption if the parent enterprise to be exempted is a joint-stock company whose shares are admitted to trading on the official market or where shareholders whose participation exceeds certain percentages have applied for the preparation of consolidated financial statements and a group directors' report no later than six months before the end of the accounting year of the group of companies.

Investment incentives

The Federal Republic, the *Länder* and local authorities grant a range of investment incentives in the form of subsidies, credit facilities, loan guarantees and special tax-depreciation rates, within the parameters of permissible state aid.

Investment grants

Investment grants of 12.5% to 27.5% of investments in some parts of Eastern Germany can be claimed by manufacturing, manufacturing-related services and accommodation industries. The grant is receivable for investments in new moveable fixed assets (other than cars or aircraft) or commercial buildings which must be retained for at least three years (in the case of small and medium-sized companies, i.e. those with a balance-sheet total not exceeding EUR 43 million (USD 54.997 million) and turnover not exceeding EUR 50 million (USD 63.950 million) or five years (large companies). Investments have to be made after 31 December 2006 and before 1 January 2010. Investment grants from the federal authorities are tax-free income in the hands of the recipient. They do not produce depreciable costs for the relevant asset.

Investment subsidies

Investment subsidies are granted by the individual *Länder* for investments in the Eastern *Länder*, in Berlin and in certain parts of Western Germany. The subsidies are available to permanent establishments located in the qualifying territories on all business assets except cars.

Before making an investment, an investor must file an application with the Ministry of Economics of the State (*Land*) in which the business is or will be located. The Ministry decides whether the planned investment is to be granted a subsidy. Approval practice varies from State to State. The most important fact considered when making the decision to promote an investment or not is the creation of jobs. In contrast to investment grants, subsidies are taxable. An investor has the option to reduce the depreciable base of the acquired assets or to recognise the subsidy as income.

Other investment incentives

- benefits from local authorities or State governments, such as sale of land at a reduced price or low rents, improvements in infrastructure, new roads and low utility rates
- loans or grants from the Federal Ministry of Research and Technology to encourage research and the development of new technology
- loans from the Federal Employment Office for investments that will create jobs.

Financial assistance

The most important federal programme for financial assistance is administered by the Bank for Reconstruction (*Kreditanstalt für Wiederaufbau*). It offers several loan programmes at favourable interest rates to encourage trade and business. The qualification requirements for the loans differ under the various programmes, but under most programmes small enterprises receive preferential treatment. Furthermore, European Recovery Programmes (ERP) and the European Union offer support in financing if certain conditions are fulfilled.

In addition to the programmes mentioned above, there are numerous other measures in the States tailored to each individual situation.

Restrictions on foreign investment

In general Germany welcomes foreign capital, especially if employment is increased.

Under the law on foreign trade and payments, the federal Government can, under certain conditions, impose restrictions on:

- the acquisition of real estate by foreign investors
- the acquisition of ships by foreign investors
- the acquisition of companies and participations in companies by foreign investors and
- an increase in capital of domestic companies or branches owned by foreigners.

At present, however, there are no such restrictions on foreign investments in Germany.

3. The tax system

The tax structure

Taxing authorities

Taxes are levied by the federal Government, federal States (*Länder*) and local authorities. The most important taxes are federal taxes, regulated in the Income Tax Act (*Einkommensteuergesetz*), the Corporation Tax Act (*Körperschaftssteurgesetz*), the Trade Tax Act (*Gewerbesteuergesetz*), the Value Added Tax Act (*Umsatzsteuergesetz*), and the Inheritance and Gift Tax Act (*Erbs- und Schenkungssteurgesetz*). The German Ministry of Finance issues interpretative regulations as well as letter-decrees in certain cases regarding the abovementioned taxes and administers the federal laws through local tax offices (*Finanzämter*). A Central Federal Tax Office (*Bundeszentralamt für Steuern*) has been established whose main tasks are to issue VAT registration numbers, tax-exemption certificates according to the regulations of a double taxation agreement or under the EU Parent Subsidiary Directive and process refunds of German VAT and withholding taxes for foreign applicants.

Important sources of statutory interpretation in tax matters are the decisions of the various Finance Courts (*Finanzgerichte*), the Federal Finance Court in Munich (*Bundesfinanzhof*) and the Federal Constitutional Court (*Bundesverfassungsgericht*).

Principal taxes

Taxes on income and gains

- corporation tax (*Körperschaftssteuer*)
- individual income tax (*Einkommensteuer*)
- church tax (*Kirchensteuer*) (if applicable)
- trade tax on income (*Gewerbeertragssteuer*)
- solidarity surcharge (*Solidaritätszuschlag*)

Taxes on transactions

- value added tax (*Mehrwertsteuer*)
- real property transfer tax (*Grunderwerbsteuer*)
- gift and inheritance tax (*Erbs- und Schenkungssteuer*)

Taxes on property

- property tax (*Grundsteuer*)

Social security contributions

- pension insurance (*gesetzliche Rentenversicherung*)
- unemployment insurance (*Arbeitslosenversicherung*)
- health insurance (*gesetzliche Krankenversicherung*)
- nursing insurance (*Pflegeversicherung*)
- worker's compensation insurance (*Unfallversicherung*)

General

Each tax has its own personal and factual scope. One business transaction can give rise to several different tax liabilities.

Partnerships with business income are subject to trade tax on income and value added tax. The individual partners are subject to income tax on the income derived from the partnership. A corporate partner of a partnership is also subject to corporation tax on its share of the partnership profits. Companies are subject to corporation tax, trade tax on income and value added tax.

Church tax on individual income tax is only charged if the taxpayer is a church member.

A solidarity surcharge is levied on individual/corporate income tax payments and on any kind of withholding taxes.

Administration

The revenue from the main German taxes is split between the federal Government and the federal States. The majority of German tax revenue is derived from federal taxes.

The taxes are administered and collected by the Federal Ministry of Finance, the Ministries of Finance of the federal States and by various local tax offices (*Finanzämter*) throughout Germany. Every taxpayer is registered at a tax office responsible for the district of the company's or individual's residence. To identify each individual taxpayer the Central Federal Tax Agency will through the course of 2008 be issuing a special identification number, which will be valid during the taxpayer's entire economic life.

Tax audits

The tax authorities examine the tax returns submitted and make any inquiries they wish before finalising the assessment. Large companies are subject to tax audits which generally cover a three-year period. On demand, the taxpayer has to grant the tax auditor access to its EDP system for verifying the accounting records.

After such tax audits the tax authorities may raise additional tax assessments if they disagree with the taxpayer's treatment of certain items at the time of the initial tax return. The statute of limitations for the assessment of additional tax normally runs four years after the end of the calendar year. An extension of the statute of limitations for the assessment can arise if a tax audit has been started or if the tax returns have been filed later. A limitation period of between 10 to 13 years exists if tax fraud is involved.

Appeal procedures

If a taxpayer does not agree with an assessment or other specific decisions made by the tax authorities, he can appeal within a period of one month of receipt of the assessment or of the decision. The tax office that made the original assessment or the first decision handles the first appeal. If no agreement can be reached the appeal can be taken to the competent Finance Court (*Finanzgericht*). The judgment of this court can again be appealed within one month to the Federal Finance Court (*Bundesfinanzhof*), which is the supreme court in tax matters.

A direct appeal by taxpayers to the European Court of Justice is not possible. However, during a domestic legal procedure the taxpayer may request the submission of the legal issue to the European Court of Justice in a submission procedure pursuant to Article 234 of the EC Treaty.

If an income adjustment could result in double taxation in two jurisdictions the taxpayer may apply for the initiation of a mutual-agreement procedure and in some cases also for an arbitration procedure.

4. Taxes on business

Territorial scope of corporation tax

The taxable profit of a company is subject to corporation tax (*Körperschaftssteur*) and trade tax on income (*Gewerbeertragssteuer*).

Resident companies are subject to tax on their worldwide income. Non-resident 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 has neither its registered office nor its place of management in Germany.

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 corresponding branch profits. On application, foreign taxes can be deducted from taxable income as expenses.

Where a tax treaty is in place that provides for exemption method to avoid double taxation, foreign-branch profits are not included in taxable income. If the exemption method is used, foreign-branch losses are not tax-deductible and foreign taxes cannot be credited or deducted. This rule was recently upheld by the European Court of Justice in the *Lidl Belgium* case (C-414/06), except, as regards within the European Union and the European Economic Area, to the extent that the loss has become definitively excluded from all possibility of set-off in the country of origin).

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 company or in the form of management fees, interest, royalties or rents. See under 'CFC rules' below for instances where this principle is overridden.

Corporation tax system

Taxable entities

Corporation tax (*Körperschaftssteuer*) is primarily a tax on companies and certain other entities. A partnership is not a taxable entity for corporation tax purposes.

Partnerships

Generally a partnership's taxable income is computed in the same way as that of a company.

Since a partnership is not a taxable entity as such for corporation tax (or income tax) purposes, profits and losses of a partnership are attributed directly to the partners and are then subject to income tax in case of individual partners or corporation tax in the case of corporate partners. Nevertheless, for trade tax purposes a partnership with business income is regarded as a separate entity and therefore has to pay trade tax (see below, under 'Trade tax').

Remuneration paid by a partnership to a partner for services rendered, interest paid on a loan from a partner, or rentals for property leased by a partner to a partnership, constitute business expenses for the partnership but increase the partner's share in the partnership's profits.

Joint ventures

There are no special provisions in German tax law for joint ventures. If the joint venture is carried on in the form of a partnership, the tax treatment is that applicable to partnerships.

Non-profit-seeking organisations

A non-profit-seeking organisation (abbreviated NPO) is an entity whose primary objective is to support an issue or matter of private interest or public concern for non-commercial purposes. NPOs may act in an innumerable range of areas relating to healthcare, arts, charities, education, politics, religion, research, sports or other purposes serving the public good. The NPOs and their public-benefit scope of business, by this definition, is a field of activity that is distinct both from the rest of the private economy and from the public sector. Therefore the business area NPOs are working in is sometimes called the 'third sector'.

A crucial organisational characteristic of NPOs as defined in tax law is the commitment that is made to refrain from using profits for the organisation's own benefit. This commitment, which is what distinguishes public-benefit bodies (NPOs) above all from the profit-seeking private sector, forms the decisive criterion in the Fiscal Code for granting important tax privileges.

However, the tax privileges for NPOs do not require a business not to make profits. On the contrary NPOs are allowed – within special limitations – to accept, hold and disburse money and other things of value. Only the appropriation of the profit that has been earned is restricted. As a basic principle NPOs, for example, are not allowed to pay dividend distributions to the owners or shareholders and may not enrich their directors or other third parties in common.

The profit generally has to be used for the scope of public benefits as described in the constitution of the association. It is not required that the NPO create the public benefits in Germany. Despite the fact that the German tax authorities do have a restrictive point of view regarding this matter, the German courts hold the view that realising beneficial purposes in foreign countries is consistent with the German Fiscal Code.

As already mentioned, NPOs do have tax privileges regarding corporation tax, trade tax, real property tax and capital yields tax. Beneath the ideal and capital sphere of a NPO (i.e. donations or asset management, which are both exempt from corporation tax and trade tax), an NPO's economic activities need to be classified into two different spheres. A variety of business affairs serving the abovementioned public benefits (as hospitals, nursing homes, research establishments, charitable institutions, etc.) are exempt from corporation tax and trade tax. Only the business operations unrelated to the beneficial purposes are liable to tax.

NPOs are increasingly taking a significant position in the German economy. In recent years, economic growth in Germany has been generally low. However, this general statement is not applicable to the area NPOs are working in. The 'third sector' and its enormous economic growth in recent years is steady and is likely to continue. Since the 1970s the number of people employed by NPOs has tripled. Especially facilities encouraging handicapped or elderly people, hospitals and constitutions serving youth and family-welfare services have experienced an enormous increase in employment.

Recent legislation (the Furtherance of Involvement in Civil Society Act 2007 – *Gesetz zur weiteren Stärkung des bürgerschaftlichen Engagements*) has made substantial changes for individuals and companies making donations or granting benefits to the capital reserve of charitable foundations, as well as making some formal modifications in the German Fiscal Code concerning NPOs' tax-privileged purposes. For instance, the limit for tax-deductible donations by individuals and companies has increased from 5% (in special cases 10%) to 20% of taxable income. The alternative maximum limit regarding the deductibility of donations has increased from 0.2% to 0.4% of the total amount representing turnover plus the company's payroll expenses in one calendar year. This maximum limit is especially important for companies with low profits.

In addition, contributions of up to EUR 1 million (USD 1.279 million) per annum can be made to an organisation acknowledged to be a charitable foundation, reducing the income tax base.

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.

Corporate tax reform

In the year 2007 Germany´s much-heralded and much-discussed corporate tax reform was approved by the German *Bundestag* and *Bundesrat*. Most of the measures generally have an effective date of 1 January 2008.

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 for domestic dividends received for companies and a 40% dividends-received exemption for individuals (part-income method).

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.

Royalty income

Royalties constitute taxable income. Any foreign withholding tax may either be offset against corporation tax or deducted as an expense, subject to certain limitations. According to the EC Interest and Royalties Directive, starting from the year 2004, royalties received by a German company from an EU company are exempt from withholding taxes in most Member States.

Non-taxable income

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

Deductions

Payments related to the costs of construction or acquisition of capital assets must be capitalised as part of the asset cost in the balance sheet. Therefore these costs reduce the tax base only indirectly in the form of higher depreciation.

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. In calculating depreciation, only the straight-line method is allowed (the reducing-balance method was abolished with effect from 2008). Examples of normal depreciation rates are:

Table 3

Type of asset	Depreciation rate (%)
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 and permanently lower than the book value, there is a possibility of extra depreciation in the form of an impairment write-down to the lower market value.

Extraordinary depreciation allowances are available in certain circumstances.

Employee remuneration

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.

Management fees

These are deductible if they are 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.

Interest payable – general

Interest expenses are generally deductible when they become payable (except with respect to the German interest-barrier rule – see below). Under the EC Interest and Royalties Directive, interest paid to a related party in different EU countries is not subject to German withholding tax.

Interest payable – restriction

Net interest expense (interest expense less interest income) is deductible only to the extent that it does not exceed 30% of the entity´s earnings before interest, taxes, depreciation and amortisation (EBITDA). Interest for the purposes of these rules includes expenses on all instruments on which the holder is entitled to a return on capital, including discount instruments of which the company concerned is the original issuer.

Disallowed interest under this rule may be carried forward and deducted in subsequent years, subject to the overall limitation.

The limitations (generally known as the 'interest barrier rules') apply to all German-resident entities and German permanent establishments of foreign entities. They also apply to non-resident entities deriving non-trading income from Germany (such as property rentals and asset-management fees).

Any net interest in excess of 30% of EBITDA will not be deductible unless one of the following exceptions applies:

Tax threshold. Interest payments are fully deductible if the annual total amount of net interest is less than EUR 1 million (USD 1.279 million), regardless of whether the actual amount exceeds the 30% EBITDA threshold. This exception applies regardless of whether the interest is paid to a shareholder, other related party or third party.

Companies that form part of a tax group (O*rganschaft*) are treated as a single entity for the purposes of the interest limitation. Therefore, the EUR 1 million *de minimis* exemption limit applies across the group as a whole.

Non-Group Clause. The limitation of interest does not apply if the entity is not part of a group. An entity belongs to a group if it can or could be consolidated with one or more other entities in accordance with the relevant accounting standards or its finance and business policy can be uniformly determined with one or more other entities.

Companies may use this exemption only if the interest paid to substantial shareholders (holding directly or indirectly more than 25% of the shares) or persons related to such shareholders or third-party-lenders having a right of recourse against persons mentioned above does exceed 10% of the overall net interest expense of the taxpaying company.

Escape Clause. According to the so-called 'escape clause', limitation of interest does not apply to a group company if its capital ratio (ratio of equity capital to total assets of the preceding balance sheet) is either equal to or higher than that of the entire affiliated group (capital ratio comparison). If a group company's ratio falls short of the group´s capital ratio by less than one percentage point, the escape clause will be deemed to be met.

In this context the 'affiliated group' is defined as comprising the parent company of the group, which prepares the consolidated balance sheet for the whole group, and all affiliated companies. The escape clause is only available for companies if there is no 'detrimental shareholder financing' of any of the companies belonging to the same affiliated group. There is detrimental shareholder financing if a substantial shareholder, who owns directly or indirectly at least 25% of interest/shares in one of the group companies and who himself is not a part of the group has granted a loan to a group companies and the interest paid on this loan exceeds 10% of the net interest of the respective company in the respective year.

Capital gains

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 or holding period or activity. 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.

Relief is 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 case of newly constructed buildings, if the construction began within four years after disposal of the asset).

Dividends, interest and royalties

Dividends receivable

Dividends received by a German-resident company from another German-resident or foreign company are generally exempt for corporation tax purposes regardless of the size of shareholding, duration of holding period, activity requirements or double tax treaties. For trade tax purposes the exemption is granted only if there is a minimum shareholding of 15%. 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 held indirectly through a partnership.

Although dividends from domestic or foreign companies are exempt, 5% of such dividends are 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.

To diminish double taxation in the hands of the domestic individual shareholder only 50% (60% from 2009 onwards) of the dividends received are subject to personal income tax at the moment of distribution (half-income method; partial-income tax method beginning in 2009). Since 50% (60%) of the company profits distributed are subject to income tax only 50% (60%) of all related expenses and losses on sale can be deducted from the taxable income. However, the "part-income procedure" can only be applied to business income. Given that the “half-income method” only applies in the case of a profit distribution the retention of profits is therefore “privileged” with a relatively low tax rate of 15% (plus solidarity surcharge) compared to a profit distribution.

Under the previous imputation system, the corporate income tax levied at the company level was fully credited against the income-tax charge on a resident shareholder. The corporate income tax system was a split-rate system. The tax rate for retained earnings was higher than for distributed earnings.

This resulted in a reduction of the corporate income tax if retained earnings that had been subject to the full corporate income tax rate were distributed. The resulting tax credit had to be paid out in ten equal instalments.

On the other hand distributions could lead to an increase of corporate income tax up to the distribution rate if income that had been subject to reduced rates or certain tax-free income (e.g. investment grants) was distributed. In order to reflect this, there is a fixed charge to tax amounting to 3% of previously untaxed profits as determined on 31 December 2006. The charge has to be paid in 10 equal instalments from 2008 to 2017. Alternatively, the taxpayer may opt for a one-time payment.

Dividends payable

The rate of withholding tax on dividends payable to foreign companies is 20%. Tax treaties generally reduce this to 15%, 10% or 5%. Under the EC Parent-Subsidiary Directive, as implemented by Germany, dividends payable to affiliated companies resident in other EU Member States are exempt from German withholding tax provided that the foreign company has held a minimum of 15% of the shares in the German distributing company for a period of at least one year before the distribution. From 1 January 2009, the shareholding threshold is reduced to 10%. From 1 January 2008, Germany will apply the 10% threshold if the Member State in which the foreign company is resident applies the same threshold itself.

Interest

Interest income is generally taxable, whatever its origin. There is no corresponding exemption for interest received that has been subject to a restriction on deductibility in the debtor company.

Generally, withholding tax of 30 % on interest income is levied on persons subject to unlimited tax liability in Germany (companies and individuals alike). Non-residents are exempted from this interest withholding tax.

Royalties payable

Royalty income is taxable. Any foreign withholding tax may either be offset against corporation tax or deducted as an expense, subject to certain limitations. Under the EC 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.

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 EC Interest and Royalties Directive exempts royalties from withholding taxation where payment is made to an affiliated EU company within the terms of the Directive.

A German taxpayer paying dividends or royalties generally has to withhold tax at the higher, statutory rate. Non-residents can either apply for a tax-exemption certificate in advance or for a refund of the tax withheld in excess of the withholding tax applicable under the relevant double taxation treaty from the Central Federal Tax Office (*Bundeszentralamt für Steuern*). According to the EU Parent-Subsidiary Directive no withholding taxes may be retained on dividends paid if certain conditions are met. Similarly, under the Interest and Royalties Directive, interest and royalties paid to associated EU companies are not subject to German withholding tax.

Withholding taxes

Table 4 summarises the withholding taxes on income payments by German companies under domestic law. Double tax treaties may reduce these withholding rates.

Table 4

Nature of payment	**domestic recipients**		**foreign recipients**	
	corporate	*individual*	*corporate*	*individual*
Dividends and income from securities	nil	20%[3]	20%[2, 3]	20%[3]
Interest	30%[4]	30%[4]	nil	nil
Royalties	nil	nil	20%[3]	20%[3]
Certain subcontractors	15%	15%	nil	nil
Property rentals	nil	nil	nil	nil
Sportspeople & entertainers	nil	nil	0-20%[3]	0-20%[3]
Branch profits	n/a	n/a	nil	nil
Management etc fees	nil	nil	nil[1]	nil
Supervisory-board director's remuneration	n/a	nil	n/a	30%[4]
Income from a silent partnership or profit-participating loan	25%[5]	25%[5]	25%[5]	25%[5]

Notes

[1] It is generally advisable to have a written agreement in place between the two parties

[2] For dividends under the EC Parent-Subsidiary Directive, see above

[3] Plus solidarity surcharge of 5.5%, resulting in a total rate of 21.1%

[4] Plus solidarity surcharge of 5.5%, resulting in a total rate of 31.65%

[5] Plus solidarity surcharge of 5.5%, resulting in a total rate of 26.375%

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 to the previous accounting period subject to a limit of EUR 511 500 (USD 654 200) for corporation tax purposes (no carry-back is allowed for trade tax purposes). To the extent that the loss exceeds EUR 511 500 or cannot be carried back it can be carried forward and be offset against future profits up to an amount of EUR 1 million (USD 1.279 million) without limitation and then up to 60% of the remaining excess income of any future year. Losses may be pooled in case of group taxation.

If during a five-year period between 25% and 50% of a company's shares are directly or indirectly transferred to a single acquirer or to persons connected with the acquirer, the losses carried forward and current losses are proportionally forfeited (according to the percentage of the transferred capital).If more than 50% of shares are transferred during a five-year period, the entire remaining loss carried forward up to the date of transfer will be forfeited.

To prevent avoidance in situations where four or more unrelated persons could acquire 25% or less of the shares, the forfeiture rules apply where ownership is transferred to a group of persons having the same intentions and objectives with respect to the loss-making entity.

The same rule applies with respect to trade tax losses carried forward and the interest carried forward under the interest-barrier rule.

Group taxation

Where German subsidiary companies (*Organgesellschaften*) are financially integrated into a German parent company (*Organträger*) and two or more companies conclude a profit and loss pooling agreement, the profit or loss of the subsidiary companies has to be transferred to the parent company. Financial integration requires that the parent company hold directly or indirectly a majority of the voting shares in the subsidiary companies. All direct and indirect holdings are aggregated to determine if a majority of the shares is held.

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 company has to be an incorporated business in all cases. An important precondition for obtaining a profit-and-loss pooling agreement accepted for tax accounting is that the agreement satisfy all prerequisites of company and commercial law.

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

Thin capitalisation

Germany's thin-capitalisation rules have been replaced by the 'interest-barrier rules' described above.

Transfer pricing

Transfer prices between related parties – and its potential impact on profits reported in different tax jurisdictions – has become of increasing interest to international tax authorities and certainly also to the German tax authorities. Like most other countries, Germany adheres to the transfer-pricing guidelines of the OECD, which require that intercompany prices comply with the 'arm's length' standard (i.e. a price that would have occurred in a marketplace transaction between two unrelated parties). The arm's length standard is incorporated into German tax law and the German tax authorities have issued numerous transfer-pricing regulations.

In Germany the traditional transaction-based methods (the comparable uncontrolled price, the resale price, or the cost-plus method) take precedence over other methods. However, in practice, the profit-oriented methods (transactional net margin and profit-split method) are frequently not only used as subsidiary methods but as corroborative methods. This means that the results achieved by application of the traditional transaction methods are tested by also using the profit-oriented methods, as far as possible. The tax authorities acknowledge that in most cases there is only a range of transfer prices or margins and for narrowing the range they accept the interquartile range or other appropriate methods. The application of the comparable profit method, which is used in the United States, is not accepted.

Generally, the German tax authorities take a very formal approach and they require that all transfer prices be agreed in a clear and unequivocal manner in advance. Consequently, they always request that written agreements be signed before the transactions take place. Furthermore, the taxpayer has to prove that the terms of the contractual agreement are being complied with in practice. The transfer prices are usually audited when a tax field-audit is performed, which normally takes place every three or four years. If the transfer prices or margins fall within the (interquartile) range, normally no adjustment can be made. The tax authorities claim that an adjustment can be made if no formal agreement has been in place before the transaction. However, there is case law that denies an adjustment for mere formal reasons because tax treaty articles which correspond to article 9 of the OECD Model Treaty allow adjustments only where the prices do not meet the arm's length test. Where prices (or margins) fall outside the range, an adjustment to the median of the range is possible.

Since the beginning of 2008, the law also requires an arm's length transfer price if business functions together with risks, assets and profit potential have been transferred to a related party abroad. The remuneration must consider the net present value of lost profits of the transferor on the one hand and the net present value of the additional profits including synergies of the transferee. Furthermore, the transfer agreement must consider a clause for retroactive adjustments within 10 years if the profit expectations turn out to be wrong.

German law requires that for all related-party transactions transfer-pricing documentation be prepared contemporaneously. Companies that have not complied with the documentation requirements are potentially exposed to penalties and double taxation if the tax authority reassesses income as a result of a transfer-pricing adjustment. Non-compliance with the documentation obligation creates a rebuttable presumption that the taxpayer has underreported his taxable income derived from transactions with related parties. If the taxpayer is unable to rebut that presumption, the German tax authorities are allowed to estimate the taxable income. If taxable income can be estimated only within a certain range, the tax authorities may adjust the taxable income applying the upper or lower end of that range. In addition, the tax authorities must impose penalties that range between 5% and 10% of the transfer-pricing adjustments (minimum EUR 5000 (USD 6400) where a taxpayer faces an adjustment, and has submitted insufficient documentation or no documentation.

If adequate transfer-pricing documentation is available but the taxpayer does not provide it to the tax authorities within 60 days (or within 30 days in respect of extraordinary transactions) after request, the penalty may be increased to no more than EUR 1 million (USD 1.279 million) (at a minimum EUR 100 per day when the time limit has expired).

Controlled foreign company (CFC) *rules*

Germany has CFC rules to prevent the diversion of profits to companies in low-tax countries. The rules generally apply where the foreign company is 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, whether corporate or individual).

Under the CFC rules a German-resident company will be subject to German tax on certain passive income that was derived by a foreign company resident in a low-tax jurisdiction but has not distributed to its German shareholders. A jurisdiction is regarded as a low-tax jurisdiction 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 shareholder 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 share of at least 1%.

Following the decision of the European Court of Justice in *Cadbury Schweppes* (C-196/04), the German CFC rules are not applied in respect of companies resident in other EU Member States or EEA countries if the following conditions are met:

- The foreign company operates in the local market and carries on genuine economic activity (i.e. stable and continuous participation in economic life, a fixed place of business for an indefinite period of time, business premises).
- An information-exchange agreement has been concluded between Germany and the other EU/EEA country concerned.

Tax rate

The uniform corporate tax rate is 15% 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 to corporation tax, a solidarity surcharge of 5.5% is assessed on the corporation tax liability (resulting in a combined rate of 15.825%). Together with the trade tax, this will result in an aggregate average tax burden of 30% (depending on the location of the business the burden can vary from 27% to 32% – see below).

Taxation of foreign companies

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

- income from a trade or business carried on 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.

Income from trade and business is subject to trade tax on income and to corporation tax at the normal rates. Income from real property is subject to corporation tax only (if certain conditions are met). 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.

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 purposes of the German branch may normally 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 (*Organträger*) of one or more German companies (see under 'Group taxation' above).

A 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.

Trade tax

Trade tax (strictly speaking, the trade tax on income – *Gewerbeertragsteuer*) is charged under the Federal Trade Tax Act, but is levied by local authorities. Every local authority is allowed to determine its own trade-tax rate for its area. The trade-tax burden on income usually ranges between 8.75% and 17.15% of business income. The minimum tax rate is around 7%.

Trade tax was previously deductible for the purposes of corporation tax and the trade tax itself as an expense against taxable income within the year of assessment. This deductibility was abolished with effect for 2008. However, relief for trade tax is still available to a certain extent for individuals (see Chapter 5).

The tax base for trade tax purposes is calculated on the basis of pre-tax income as determined for corporation tax purposes, with the following main adjustments.

Additions

- 25% of interest payable in respect of all short-term and long-term loans and payments assimilable to interest (such as factoring discounts) are added back to taxable income. These rules apply only to interest that is an allowable expense for corporation tax purposes
- further add-backs will be made for specific proportions of royalties paid (6.25%) and asset leasing payments (up to 16.25% in the case of leases of immovable property).
- add-backs calculated by the two bullet points above are made only as far as the total exceeds EUR 100 000 (USD 127 900).
- tax-exempt dividends from shareholdings of less than 15% in domestic or foreign companies;
- losses from foreign branches and 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 15% in domestic or active foreign companies.

Losses

As with corporation-tax losses, trade losses can be carried forward for an indefinite time. Only the first EUR 1 million (USD 1.279 million) may be offset in their entirety by losses. To the extent that profits exceed this threshold, only 60% of the excess is available for offset by losses. No loss carry-back is available.

Partnerships

Although partnerships are transparent entities for the purposes of corporation tax and income tax, they are separately liable as such for trade tax.

Rates of trade tax

The tax is levied on a base of 3.5% of adjusted income, to which each local authority applies a multiplier usually ranging from 250% to 490%. The effective rate thus usually ranges between 8.75% and 17.15% of income.

Tax computations

For a trade tax rate of 14%, the combined corporation and trade tax burden generally amounts to approximately 30% in the case of undistributed profits and 45% (including withholding tax of 20%) in the case of distributed profits. In the latter case German-resident shareholders can normally credit the withholding tax against their own tax. With respect to foreign shareholders, in almost all cases the withholding tax is either reduced by tax treaties or mostly can be credited against foreign taxes.

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 inapplicable to profits repatriated by a German permanent establishment to its foreign head office, the total tax burden of 30% is final.

	Company		Branch of foreign company
	with maximum treaty relief	**without treaty relief**	
Income before tax	100.00	100.00	100.00
Trade tax (14%, average tax rate) *	-14.00	-14.00	-14.00
Corporation tax (15%)	-15.00	-15.00	-15.00
Solidarity surcharge	-0.83	-0.83	-0.83
Income after taxes	70.18	70.18	70,18
Total income taxes (before distribution)	29.83	29.83	29.83
Profit Distribution: Dividend	70.18	70.18	
Withholding tax (0% - 20%) **	-0	-14.04	
Solidarity surcharge (5.5%)	-0	-0.77	
Available to parent (domestic/foreign)	70.37	55.37	70.18
Total income taxes after distribution	29.63	44.63	29.83

Compliance, returns and payments

Compliance

The German tax system is not based on self-assessment (with the exception of VAT). The management of a company is instead obliged to file a tax return reporting the company's taxable income. If the return is not filed by the due date (including extensions), the tax authorities may assess the tax on an estimated amount and impose a penalty of up to 10% of the assessed tax, not exceeding a maximum amount of EUR 25 000 (USD 31 975). Since taxes are based on information in the return as given by the taxpayer, there are sanctions to prevent incomplete or inaccurate returns.

Tax returns

The annual tax returns for corporation tax and trade tax are due on 31 May following the end of the calendar (fiscal) year. A general extension until the end of December following the end of the calendar year is granted if a certified tax adviser, certified public accountant or a lawyer represents the taxpayer provided that no advance demand has been communicated by the tax office. A further extension until the end of February of the following year is applicable on special application by the abovementioned tax professionals. If the deadlines are exceeded, late-filing penalties may be assessed.

When filing its annual tax returns, the company must enclose the balance sheet and income statement, including the notes to the financial statements and reconcile the taxable income in the tax return with the income in the financial statements.

Trade-tax returns have to be filed electronically.

Payment and collection

Corporation tax and trade tax chargeable in a tax assessment are due one month after the taxpayer has received the notice of assessment.

The tax authorities fix quarterly advance payments based on the preceding assessment for corporation tax and trade tax. The advance payments have to be made as shown in Table 5:

Table 5

Corporation tax	Trade tax
10 March	15 February
10 June	15 May
10 September	15 August
10 December	15 November

It is possible to apply for a reduction of advance payments where a taxpayer recognises during the year that the income will be lower than in the previous year. If the tax finally assessed exceeds the amount of prepaid taxes, an interest charge of 0.5% per month is levied on payments made later than 15 months after the end of the respective year. If taxes have been overpaid, the same conditions will hold for interest on refunds.

Salary tax

Employers must also remit income tax (salary tax) withheld from their employees, as well as social security contributions withheld from salaries and wages monthly and must also pay the employer's share of social security contributions. Salary-tax returns have to be filed on a monthly or quarterly basis (depending on the amount of tax payable).

If taxes are not paid or are paid late, the tax authorities assess a penalty of 1% of the amount due for each month of delay. If the delay does not exceed three days, no penalties are assessed. This extension is not applicable for VAT and salary tax payments.

Tax audits

The tax authorities examine the tax returns submitted and make any inquiries they wish before finalising the assessment. Large companies are subject to tax audits generally covering a three-year period. On demand, the taxpayer has to grant the tax auditor access to its EDP system for verifying the accounting records.

After such tax audits, the tax authorities may raise additional tax assessments if they disagree with the taxpayer's treatment of certain items at the time of the initial tax return. The statute of limitations for the assessment of additional tax normally runs four years after the end of the calendar year. An extension of the statute of limitations for the assessment can arise if a tax audit has been started or if the tax returns have been filed later. A 10 (respectively up to 13)-year period is applicable if tax fraud is involved.

Appeal procedures

If a taxpayer does not agree with an assessment or other specific decisions made by the tax authorities, he can appeal within a period of one month after receipt of the assessment or of the decision. The tax office that made the original assessment or the first decision handles the first appeal. If no agreement can be reached the appeal can be taken to the competent Financial Court (*Finanzgericht*). Appeals against a decision of the Financial Court may be made within one month to the Federal Financial Court (*Bundesfinanzhof*), which is the supreme court in Germany for tax litigation. However, where the point at issue is constitutional (as with the Inheritance and Gift Tax – see below), the final decision rests with the Federal Constitutional Court (*Bundesverfassungsgericht*).

A direct appeal by taxpayers to the European Court of Justice is not possible. However, in the course of domestic litigation, the taxpayer may request that a question be referred to the European Court of Justice in a submission procedure pursuant to Article 234 of the EC Treaty.

If an income adjustment (in a transfer-pricing case, for example) could result in double taxation in two states, the taxpayer may apply for the initiation of a mutual agreement procedure and in some cases also for an arbitration procedure.

Value added tax (VAT)

In principle, all business undertakings are subject to value added tax (VAT – *Mehrwertsteuer*) whether the business is unincorporated or incorporated and whether the business is a domestic or a foreign one. VAT is levied at each stage of the production and distribution cycle with the purpose of ultimately burdening the end-consumer. Businesses that supply goods and services liable to VAT are generally entitled to deduct paid VAT as input VAT.

Chargeable Event

VAT is charged on supplies of goods and services effected within Germany for consideration by an enterprise in the furtherance of its business except for cases where the German VAT Act (*Umsatzsteuergesetz*) explicitly grants an exemption.

A supply of goods is defined as the transfer of the right to dispose of tangible property as owner. The comprehensive term ‘supply of services’ includes all other taxable transactions that do not qualify as a ‘supply of goods’ and covers any and all activities that can be the object of an agreement. Furthermore, the supply of goods and services comprises:

- the withdrawal of business property for non-business purposes
- the use of business goods and services for non-business purposes and
- the attribution of goods free of charge

VAT is also charged on:

- the importation of goods from non-EU countries and
- the intra-Community acquisition of goods within Germany for consideration.

The transfer of a business or an independent part of an undertaking including tangible elements and, as the case may be, intangible elements which, together, constitute an undertaking or a part of an undertaking capable of carrying on an independent economic activity (‘the transfer of a going concern’) is not regarded as a taxable transaction. The transfer can be made for consideration or for no consideration or as a contribution to a company and must be made in a single transaction and from one taxable person to another person who qualifies already as a taxable person or who becomes a taxable person as a result of the transfer.

Intra-Community dispatches and acquisitions

Regarding intra-Community dispatches and acquisitions special provisions apply. In the European Union VAT on cross-border sales is in most cases paid by the purchaser in the country of destination of the goods (intra-Community acquisition). Enterprises carrying out intra-Community dispatches are required to submit quarterly returns to the tax authorities (so-called 'aggregated sales listings'), which contain the VAT identification numbers of the purchasers outside Germany and the total value of goods exported to them. A German VAT registration number can be obtained from the Federal Central Tax Office upon filling out a questionnaire and providing documentation about the business.

Basis of assessment

VAT due is assessed on the contractual consideration exclusive of VAT. VAT on imports from non-EU countries is levied on each individual import and assessed on the customs value of the imported goods.

Tax rates

In Germany two rates of VAT exist: the standard rate of 19% and the reduced rate of 7%. The standard rate of 19% applies to all supplies of goods and services not specified as subject to the reduced rates. The reduced rate of 7% applies to goods and services such as food and beverages, books, certain works of art and collector's items (Schedule 2 to the VAT Act). Before 1 January 2007, a lower standard rate of 16% was applicable.

Exemptions

The main types of exempt supply are as follows:

- the export of goods and intra-Community deliveries
- the delivery of certain items such as potatoes, olives, and corn if the items are stored in a VAT warehouse in connection with delivery or if the items are already located in a VAT warehouse at the time of delivery and do not leave the VAT warehouse in the course of the delivery
- the supply of goods before customs clearance, if the recipient accounts for the import VAT
- certain commissions of agents acting for foreign principals
- most banking and insurance activities
- leasing and sale of real estate
- medical, educational and charitable services

Please note that for the applicability of the exemptions for exports and intra-Community deliveries certain documents have to be furnished by the enterprise.

VAT *grouping*

VAT grouping is permitted in Germany. For VAT purposes group taxation can be achieved without a profit-and-loss pooling agreement. However, unlike the situation for corporation tax and trade tax, it is 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 VAT purposes.

VAT *liability*

In general, it is the supplier who is liable for the VAT due. For certain supplies of goods and services made by non-resident taxable persons to other taxable persons in Germany, the customer rather than the supplier has to withhold, report and pay VAT (this is the so-called 'reverse-charge procedure'). The customer is held exclusively liable for the VAT. For the application of the reverse-charge procedure, the invoice must be raised for the net amount and must explicitly state that the customer is liable for the VAT. Please note that the VAT liability is shifted irrespective of the nationality of the recipient.

The reverse-charge procedure is, for example, applicable to:

- supplies and installations of goods and to almost all types of services carried out by a foreign taxable person in Germany if the recipient is a taxable person or a legal entity governed by public law (e.g. university, local hospital)
- supplies that are subject to real estate transfer tax (*Grunderwerbsteuer*), provided that the option to tax was chosen and the transferee is a taxable person or a legal entity governed by public law
- certain types of construction services provided that the customer also performs construction services

On the other hand, the reverse-charge procedure never applies to transactions such as:

- certain types of passenger transport
- entrance charges for fairs, exhibitions and congresses in Germany and the supply of services by an implementing body, insofar as this service supply is in connection with the organisation of fairs and exhibitions in Germany.

Input-Tax deduction

Taxable persons may deduct the following items as input VAT when computing the balance of tax payable to the authorities, provided that they are in possession of the necessary documents such as proper VAT invoices, etc:

- VAT paid to the seller of goods or provider of services in Germany,
- VAT paid on imported goods from non-EU countries and
- VAT paid for intra-Community acquisitions.

Input VAT charged on supplies of goods or services that the taxable person uses for tax-exempt transactions cannot be reclaimed in principle. Thus, where a taxable person has both taxable and exempt transactions, the VAT paid by him and attributable to the exempt turnover is not recoverable. This restriction is applicable neither to exports nor to intra-Community deliveries and some other supplies.

Requirements for proper VAT invoices

The taxable person will have to ensure that a proper VAT invoice is issued with respect to all supplies of goods and services to other taxable persons, to non-taxable legal persons, for real-estate related services, or contracts for work and materials supplied to private individuals or taxable persons for their private use within six months from the time of supply. The mandatory information on a proper VAT invoice is generally:

- the full name and address of the taxable person and of the customer
- the VAT number of the taxable person, starting with a two-digit country code i.e. DE for Germany, issued by the Federal Central Tax Office
- the date of issue of the invoice
- a sequential identifying number (the identifying number (invoice number) should be based on one or more series uniquely identifying the invoice)
- a description identifying the quantity and the nature of the goods or the extent and the nature of the services rendered
- the time of supply of the respective goods or services (this can also be provided on another document as long as there is reference in the invoice to this document)
- if a payment is received before the supply was carried out, the date when the payment or an advance payment is received is required as long as this date is confirmed and not identical with the date of issue of the invoice
- the consideration per VAT rate and exemption for the supply of goods or services
- a reference to reductions of the consideration agreed to in advance, if the reduction is not already included in the consideration and the customer is in possession of the underlying agreement, otherwise name and date of the underlying documents are required on the invoice

- the rates of VAT applicable as well as the amount of VAT due or a note referring to a VAT-exempt supply if applicable
- a reference that the customer has to keep the invoice, a confirmation of payment or other probative document for two years (only applicable on invoices for real-estate related services or contracts for work and material supplied to private individuals or enterprises for private use only)

Simplification regulations apply to invoices for amounts not exceeding EUR 150 (USD 190) inclusive of VAT. Such invoices must contain at least the following information, however:

- the full name and address of the taxable person
- the date of issue of the invoice
- a description identifying the quantity and the nature of the goods or the extent and the nature of the services rendered
- the sum of the consideration and the amount of VAT due for the supply of goods or services as well as the rate of VAT applicable or a note referring to a VAT-exempt supply if applicable.

Returns and payment

Taxable persons have to submit VAT returns on a periodical basis to their local tax office. In general, these so-called 'preliminary' VAT returns must be filed on a quarterly basis and electronically. However, monthly filing is required if the previous year's VAT payable exceeded EUR 6136 (USD 7850). In any case, an annual VAT return must be submitted by 31 May of the following calendar year.

Any payment due according to the annual VAT return has to be paid within one month of its submission to the tax office. The monthly or quarterly VAT return leads to payments on the 10th day of the month following the end of the reporting period. It is possible to apply for an extension of one further month. If the taxpayer has to file monthly VAT returns, a special prepayment of one-eleventh of the VAT due for the preceding year is paid in advance on 10 February.

Non-resident taxable persons

German VAT also affects taxable persons who are not located within Germany because VAT is levied whenever goods and services liable to tax are supplied within Germany. The nationality of the enterprise is not decisive. It is therefore important to determine the place of supply. For this purpose, different rules apply to supplies of goods and supplies of services.

Supplies of goods

The place of supply is generally the place where the goods are located at the time of the supply. If the goods are transported or dispatched, the place of supply is in principle where the transportation or dispatch begins. If transportation starts outside Germany there is no VAT due on the supply of the goods but there will be VAT due on importation from non-EU countries.

Supplies of services

The place of supply is generally the place where the supplier resides or has his permanent establishment, provided that the service is supplied from there. However, there are a number of exceptions to this rule. For instance, the place of supply of services connected to real estate is where the real estate is situated.

A foreign taxable person who carries out taxable transactions within Germany is obliged to file VAT returns in Germany, if the conditions for the reverse-charge procedure are not met.

From 1 July 2003, enterprises established outside the European Union and not registered for VAT purposes in a Member State have been obliged to register for VAT purposes in the European Union if they carry out so-called electronically supplied services to private customers, as the place of the supply of these services is deemed to be the place where the private customer resides. To avoid the need to register in each individual Member State in which these services are carried out, a special scheme allows the enterprise to opt for registration in a single Member State. When filing the VAT return of this Member State the turnover realised in other Member States has to be reported together with the applicable VAT rates and the calculated VAT due there.

Non-resident taxable persons who do not perform taxable transactions in Germany may claim recovery of input tax incurred through a special refund procedure governed by the terms of the EC Eighth VAT Directive (in the case of persons from other Member States) or the EC Thirteenth VAT Directive (in the case of third-country residents). The fixed time limit for filing a refund application with the Federal Central Tax Office is six months after the end of each calendar year.

5. Taxes on individuals

Income tax

Territoriality and residence

Under German income-tax law (codified primarily in the Income Tax Act – E*inkommensteuergesetz*) individuals who are resident in Germany are taxed on their world wide income (they are said to have 'unlimited tax liability' – *unbeschränkte Steuerpflicht*), whereas non-residents are taxed only on certain German-source income (they are said to have 'limited tax liability' – *beschränkte Steuerpflicht*). An individual's nationality is of no importance in determining taxable income and the amount of German income tax due. Double tax treaties may restrict Germany's taxation rights and assign them to another country.

Trade tax (see above) applies only to business activities conducted in Germany.

For the purposes of inheritance and gift tax there are special rules, which are described in detail below.

Residence

An individual is deemed to be resident in Germany if his or her:

- permanent place of residence (W*ohnsitz*) or
- habitual place of abode (*gewöhnlicher Aufenthalt*)

is within the territory of Germany.

A continuous physical presence in Germany of more than six months will lead to the assumption of a habitual abode in Germany from the beginning of this period. Short absences are disregarded for tax purposes.

A non-resident is an individual with neither a permanent place of residence nor a habitual place of abode in Germany.

Non-resident status has the advantage of being subject to German taxation with respect to certain German-source income only. However, this status also has disadvantages, e.g. that usually fewer deductions can be claimed determining the amount of the taxable German income, or that other benefits like the special tax rates for couples are not available. To avoid most disadvantages, non-residents whose calendar-year income is at least 90% subject to German income tax, or whose calendar-year income not subject to German income tax is not higher than the basic tax-free amount (i.e. EUR 7664 (USD 9800) in 2008), may apply to be taxed (on their German taxable income) as if they were resident in Germany. If they are a citizen of an EU Member State or EEA country, it is possible on application to treat them and also their family members as unlimited taxpayers in Germany. Therefore, for example, the more favourable tax table for couples filing jointly may be available to them.

Categories of taxable income

German residents are subject to income tax on seven categories of income:

- agriculture and forestry
- trade and business
- independent personal services
- employment
- capital investment
- rents and royalties and
- certain other income (e.g. personal pensions, private capital gains)

The net income from each of the seven income sources is calculated separately (income after deduction of expenses) and then added together. From this total, special tax allowances are deducted to arrive at the taxable income. Profits that do not fall within the seven income sources are tax-free (e.g. lottery winnings, sale of privately owned capital assets except for the capital gains derived from transactions realised within a defined time frame – see under 'Capital gains' below). However, income that falls within one of the seven categories may also be tax-free within certain limits.

Tax year

The tax year for income-tax purposes is the calendar year. In case of proprietors of businesses permitted to have a period of account not corresponding to the calendar year, it is the income of the period of account ending in the calendar year that is the income taxable in that calendar year.

Treatment of the family unit

A married couple who are living together and both resident in Germany are taxed jointly. Their incomes are aggregated and they file a joint tax return. However, they may opt to be taxed separately. In general the joint tax return is more favourable for married couples especially if the income of one spouse exceeds the income of the other spouse.

The income of minor children is not aggregated with that of their parents and is taxed separately.

Income from employment

Income from employment includes all benefits in cash and in kind received by an individual with respect to an employment. The benefits include but are not limited to:

- benefits for active employees, such as fixed salaries and wages, profit participation and other variable remuneration, as well as bonuses
- benefits-in-kind (e.g. private use of company car)
- compensation paid for the termination of an employment relationship and nearly all other pensions not from the public social security system, such as pensions from former employers

German-source employment

German-source salaries are generally taxable in Germany whether the individual is a resident or not.

Foreign-source employment

Remuneration from foreign sources may be taxed if the individual is resident in Germany but most of Germany's tax treaties exempt certain income from German tax. Nevertheless, in the procedure known as 'exemption with progression' (*Progressionsvorbehalt*), this exempt income is taken into account when determining the applicable tax rate on the taxable German income.

Treatment of company directors

In Germany, the treatment of directors differs according to their function. Executive directors (members of the executive board (*Vorstand*) of a joint-stock company, managing directors (*Geschäftsführer*) of a limited-liability company, etc.) are treated as employees. Members of the supervisory board (*Aufsichtsrat*) of a joint-stock company with no managerial or executive duties are treated as self-employed professionals, however. If they are non-resident, their remuneration is subject to a final withholding tax of 30%.

Benefits-in-kind

The general rule is that the value of fringe benefits received or enjoyed from an employment is included in the taxable income of the employee. The taxation of fringe benefits is subject to special rules in some cases. Small tokens or gifts are excluded, e.g. free tea or coffee, flowers or books not exceeding EUR 40 (USD 50) in value, etc.

If the employer provides the employee with a company car for private use, the benefit-in-kind is subject to tax. In most cases the benefit is valued at a monthly equivalent of 1% of the manufacturer's list price (inclusive of VAT). If the employee uses the company car for commuting, there is an additional monthly benefit charge of 0.03% of the list price of the car per kilometre of the distance between home and work. It is assumed that the employee uses the company car between home and work on 180 days in the year. It could be advantageous to keep a complete driving record as the alternative method of valuing the benefit. In this case the total expenses (including a depreciation allowance) of running the company car are divided by the proportion of private mileage to total mileage. This method may be used only if a complete driving record (log book) is kept.

Where an employer makes any business assets available for the personal use of an employee, the market value of the benefit derived by the employee from that personal use is in general included in the employee's taxable income.

Deductible expenses of employment

In general, an employee may deduct expenses incurred in order to carry out the employment, such as expenses for a business-related double household, business-related education, work materials and others. For certain expenses, standard (lump-sum) deductions may be claimed, and any employee may claim a deduction of EUR 920 (USD 1175) per year whatever the level of actual expenses incurred. Where expenses exceed this figure, and are not covered by a standard deduction, the actual amount incurred may be claimed if there is substantiating evidence. The employee may deduct commuting expenses of a fixed amount of EUR 0.30 per kilometre (one way) if the distance between home and work place is more than 20 kilometres, subject to an annual maximum of EUR 4500 (USD 5750).

Tax-free reimbursements

Tax-free allowances by an employer to an employee are possible only for a limited list of expenses. For example, under certain further preconditions it is possible for the employer to reimburse special business travelling expenses or costs of work tools (e.g. working clothes). Certain extra expenses incurred by employees who are obliged to maintain two households (because their home is too far from their place of work) may be reimbursed to the employee tax-free.

Salary tax

Employees' income tax on their remuneration is withheld as salary tax (*Lohnsteuer*) by the employer, who is then responsible for remitting this sum to the tax authorities on the employee's behalf.

The criteria relevant to the calculation of income tax to be withheld are contained in the so-called 'salary-tax card' (*Lohnsteuerkarte*), which is supplied by the tax authorities to resident employees and handed over to the employer. At the year-end, or on termination of employment, the employee receives a certificate from the employer showing the tax withheld. The tax withheld is credited against the income tax liability according to the employee's return and is refundable in cases where too much income tax has been withheld.

Income from employment is also subject to solidarity surcharge on tax and church tax (if applicable).

German subsidiaries of foreign companies are obliged to withhold salary tax for personnel who are under transfer from the parent. This regulation applies for subsidiaries that are not the legal employers of the personnel but that will effectively bear the cost of the employees. It is not necessary that the subsidiary directly pay the employee's salary for the rules to apply. The same provision applies for permanent establishments of foreign companies employing personnel.

Self-employment income

For the purposes of German income tax, earnings that are not derived from an employment relationship may fall into any one of three different sources:

- the income of farmers or others from agriculture and forestry
- income from a trade or business (e.g. shopkeeping, crafts, skilled trades) and
- income from independent personal services

Income of a sole proprietor or of a partner from a trade or business is distinguished for tax purposes from income from independent personal services. The latter class of income generally comprises income from a profession or vocation (e.g. architecture, the legal profession, the accountancy profession, medicine etc). Income from independent personal services includes the profits of freelancers but also of members of the so-called 'liberal' professions (*Freiberufe* – e.g. scientists, artists, journalists, authors, engineers, architects, doctors, lawyers, public notaries, qualified public accountants and tax advisers). Income from professional partnerships is in general also included in this income category.

It is essential to differentiate between income from trade and business and income from independent personal services in general on the one hand and income from a liberal profession on the other hand. The former categories of income are liable to trade tax, but the latter is not. In the case of persons engaged in farming and forestry, those entered in the Commercial Register (*Handelsregister*) are liable to trade tax as are those whose turnover from trading exceeds a *de minimis* threshold.

Business income and private income

Income from agriculture and forestry, trade and business and independent personal services is grouped together as 'business income', whereas income from employment, investment income, rents and royalties and miscellaneous other taxable income is classed as 'private income'. The distinction between business and private income (see below) is of importance, for example, because of the different taxation of capital gains and different methods in determining the amount of taxable income (see variously below).

Income determination

Business income (income from agriculture and forestry, trade and business, independent personal services) is determined in several different ways. Business people (e.g. sole traders, independent agents) are obliged to prepare accounting records with annual balance sheets and income statements. Individuals with secondary business income (especially from agriculture and forestry as well as independent personal services) are in general allowed to determine their income as the balance of income less expenses, unless otherwise requested by law or elected by the individual.

Private income (income from employment, investment, rents and royalties, other income) is determined under the cash receipts and disbursements method.

Income-related deductions and tax-free allowances

In general it is only possible to deduct income-related expenses actually incurred, but sometimes also lump-sums may be deducted (e.g. for meal expenses in case of business travel).

In general, all income-related expenses may be deducted, regardless of their character as business or private income. There are some restrictions regarding, for example, entertainment expenses or gifts to business friends, car and travel expenses, maintenance of two households, or meal expenses in case of business travel.

Option for corporate treatment

For income-tax purposes, individual partners in a partnership have the option to apply for the partnership's retained earnings to be taxed in a similar manner to those of companies. This option will, however, only be granted to the partners of a partnership who have an interest of more than 10% or whose profit share exceeds EUR 10 000 (USD 12 790). The retained income will then initially be taxed at a reduced rate of 28.25%. As a consequence of the trade-tax rate-relief allowance (see below under 'Rates of income tax – tax credits'), the income-tax burden will be diminished accordingly. The solidarity surcharge of 5.5% is calculated based on the income tax less trade-tax rate-relief allowance. On later distribution, any excess of withdrawals over contributions (to the extent it exceeds the profits of the partnership) will then additionally be taxed at 25% plus solidarity surcharge at the level of the receiving partner.

The reduced tax rate requires a separate application per fiscal year and per sole-proprietorship interest or partnership interest. The application is limited to the amount of retained profit and can be withdrawn at any point before the income tax assessment of the next fiscal year has become final (for example to enable a loss carry-back).

Additional taxation to restore the *status quo ante* will not only take place where there is a profit distribution (as above) but also in the case of a sale or termination of the business, on a contribution, or on a change of legal form (e.g. incorporation).

For each fiscal year a separate annual assessment of the potential amount subject to additional taxation is carried out.

Income from capital investment

Income from capital investment namely includes dividends, profit distributions received as a typical silent partner (*typischer stiller Gesellschafter*) who is not to be compared with person engaged in business, and interest.

Interest income is fully taxable at normal tax rates. Profit shares of a typical silent partnership are also subject to normal tax rates. Please note that investment income is generally subject to withholding taxes at rates of between 20% to 30% plus solidarity surcharge (see Chapter 4, Table 4 above) which may normally be credited against the recipient's liability to income tax.

Dividends

For individual shareholders in German companies, only 50% of the dividend received is subject to income tax, the remaining 50% being exempt. By the same token, only 50% of the income-related expenses are deductible). This kind of taxation is referred to as the 'half-income procedure'.

Interest

Interest income is fully taxable at normal progressive tax rates.

Exemptions and deductions

For income from capital investment there is a standard deduction of EUR 51 (USD 65) for income-related expenses and an additional saver's exemption of EUR 750 (USD 950) (both amounts are doubled for couples filing jointly).

The part-income procedure

From 1 January 2009 the half-income procedure will be replaced by the 'part-income procedure' (*Teileinkünfteverfahren*) or by flat-rate taxation. According to the 'part-income procedure', 60% of the dividend received will be taxable. As a consequence, 60% of the related expenses will be deductible. However, the 'part-income procedure' will be applicable to business income only. In all other cases, a flat and final withholding tax rate of 25% (plus solidarity surcharge, therefore effectively 26.375%) will be applied to all kinds of non-business investment income such as dividends, interest and capital gains. There will be a saver's standard exemption of EUR 801 for singles and EUR 1602 for couples filing jointly but the standard deduction will be withdrawn.

In order to avoid hardship, taxpayers adversely affected by the flat tax may apply to the tax authorities for assessment to normal progressive tax rates.

Rents and royalties

Income from rents and royalties include income from the leasing of immovable or movable property or from a licence to use intangibles for a limited time.

Other income

Other income includes income of a recurrent nature (e.g. annuities and other recurring payments and benefits, but also pensions from the public social security system), special private capital gains and income from miscellaneous sources that cannot be classified under other categories. See below regarding pensions from the public social security system and capital gains.

Pensions from the social security system

Most former employees receive state retirement pensions. A peculiarity regarding the taxation of these pensions results from the fact that they have at least been partly financed by the pensioners' previous social security contributions out of taxable income.

New rules regarding the taxation of state retirement pensions were introduced in 2005. The intention is gradually to change to a full basis of taxation.

For individuals who retired in 2005 or earlier, only 50% of the retirement pension is taxable for as long as they live. For persons retiring between 2006 and 2020, the taxable percentage of the retirement pension increases in 2% steps each year. In the years 2021-2040, the taxable percentage will increase by 1% steps each year. Thus individuals retiring in 2008 pay tax on 56% of their retirement pension, whereas someone retiring in 2022 will be taxable on 82% of his or her retirement pension.

Private and occupational pensions

The rules described immediately above do not apply to private and occupational pensions, which are fully taxable. However, for the fiscal year 2008 there is a pension allowance of 35.2% of the total private and occupational pension receivable, subject to a maximum allowance of EUR 2640 (USD 3375). In subsequent years, the pension allowance will be reduced to zero by 2040. The allowance is lowered in steps of 1.6 percentage points until 2020, then in steps of 0.8 percentage points until 2040.

Capital gains

Capital gains derived from agriculture and forestry, trade and business or independent personal services are included in the respective category of business income.

Capital gains derived by an individual from property not related to the abovementioned categories of business income are in general not subject to tax. The main exceptions are the following two cases:

Gains from private and portfolio disposals

A sale is deemed speculative if the holding period is less than ten years in the case of real estate, or less than one year in the case of other property such as shares. For all shares in companies acquired before 31 December 2008, gains on the disposal of those shares will not be subject to tax if the holding period is equal to or greater than one year and the taxpayer at no time held 1% or more of the company's shares. For shares acquired after 31 December 2008, income from capital investment will be redefined to include capital gains on the disposal of shares constituting a participation of less than 1%. This will results in the imposition of income tax on capital gains regardless of whether the sale of shares takes place within or after a holding period of one year. The first EUR 600 of gains per individual will be exempt.

Capital gains are not taxed if they are less than EUR 512 (USD 650) per year (in the case of married persons, each spouse has his or her own tax-exempt amount).

Gains on the sale of substantial shareholdings in a company

A substantial shareholding exists if at least 1% of the share capital is held or has been held at any time during a five-year period prior to the disposal of the shares. Capital gains from such disposals are subject to income tax, but under the half-income procedure, 50% of this income is exempt, on the other hand only 50% of the income-related expenses are deductible.

From 1 January 2009, the half-income procedure will be replaced by the part-income procedure (see above).

Deductions and allowances

Specific deductions

As a rule, most costs related to taxable income are deductible. Not deductible are costs for anything related to private use, such as language courses (few exceptions possible).

Table 6 below lists the most common deductions or tax credits for the year 2008 due to personal circumstances available in computing taxable income or final tax liability.

Table 6

Deduction or allowance	Amount	Method of relief
Child care expenses	2/3 of the costs, maximum EUR 4000 per child if further requirements are met.	Deduction
Charitable donations	Maximum: 5% or 10% of taxable income	Deduction
Contributions to pensions and old age arrangements (defined special expenses)	Maximum EUR 13 200 (EUR 26 400 for a couple filing jointly)	Deduction
Insurance premiums for medical, hospital, life, accident and car insurance (defined special expenses)	Maximum EUR 2400 (EUR 4800 for a couple filing jointly)	Deduction
Donations and contributions to political parties	50% of donations and contributions up to EUR 1650 (EUR 3300 for a couple filing jointly) resulting in a maximum tax credit of EUR 825 (EUR 1650 for a couple filing jointly)	Tax credit
Social security contributions:		Deduction
• pension insurance	66% of contribution (max. EUR 13 200)	
• unemployment insurance, nursing-care insurance, health insurance, worker's compensation insurance	100% of contribution in each case, up to an aggregate maximum of EUR 2400 (where health insurance contributions are wholly or partly paid by the employer, the maximum is EUR 1500)	

Tax reduction for household-related employment and services.

The maximum tax relief for household-related employment amounts to:

- part-time domestic help: 10% of costs, max. EUR 510
- household-related employment, in respect of which social security contributions are paid: 12% of costs, max. EUR 2400

The maximum tax relief for household-related services amounts to 20% of costs, max. EUR 600. If further requirements are met, the taxpayer may be eligible for higher tax relief.

Standard personal allowance

For all taxpayers, after all specific deductions, there is a personal allowance (tax-free amount) of EUR 7664 (USD 9800). For a married couple filing jointly, the allowance is EUR 15 329 (USD 19 600).

Child allowance

Individuals with children (in general up to the age of 18, under special further preconditions up to the age of 25 if their year of birth was 1983 onwards, or up to 26 or 27 under certain conditions) receive either a tax-free child cash benefit (*Kindergeld*) or a child tax allowance (*Kinderfreibetrag*), depending on what is more favourable for the taxpayer. The child cash benefit is granted monthly in the amount of EUR 154 for the first, second and third child and EUR 179 for each additional child. It is available in respect of children living in Germany or the European Union or the European Economic Area, subject to several conditions. The child tax allowance is granted with respect to the absolutely necessary livelihood of each child in the amount of EUR 1824 and with respect to the need of care, education and professional training of each child in the amount of EUR 1080. The amounts are doubled for jointly assessed spouses who are both eligible for the allowance. Unlike the child cash benefit, this is also available in respect of children living outside the European Union or the European Economic Area. The child tax allowance will be split pro rata if the taxpayer is resident in Germany for less than a year. The tax authorities determine whether the child cash benefit or the child tax allowance is more advantageous when they assess the taxpayer to income tax. In the event that the child tax allowance is more advantageous than the child benefit, the benefit needs to be repaid to the tax authorities with the tax liability or will be deducted from the refund.

With respect to children born after 1 January 2007, there is the possibility of claiming parental benefits (*Elterngeld*). To receive parental benefits (*Elterngeld*) several conditions need to be fulfilled e.g. that one parent must stay at home to take care of the child. If the taxpayer is entitled to receive the benefit, it amounts to 67% of the last received average monthly salary for the last 12 months, up to a maximum of EUR 1800. The reference period is 12 months for parents. The reference period extends to 14 months if the taxpayer is a single parent or if the child care is split i.e. if one parent is not working for 12 months and the other parent is not working for two months.

Rates of income tax

Income tax is levied at progressive rates. In the fiscal year 2008 the liability for tax of single taxpayers starts at an annual taxable income of EUR 7665 with a rate of 15.0% and reaches a maximum of 45.0% on taxable income in excess of EUR 250 000.

For married couples living together, both of whom are resident in Germany and who file a joint return, the so-called 'splitting' table is applied. Splitting gives rise to an equal division of the taxable income between husband and wife which, because of the progressive nature of the tax rates, leads to a lowering of the progressive rates applied. This privilege is also applicable to individuals from other EU countries under certain conditions.

Table 7 indicates the income taxes payable by single persons and married couples for the fiscal year 2008.

Table 7

Single taxpayers			Married taxpayers filing jointly		
Annual taxable income (EUR)	**Marginal rate (%)**	**Tax payable (EUR)[1]**	**Annual taxable income (EUR)**	**Marginal rate (%)**	**Tax payable (EUR)[1]**
up to 7664	0	0	up to 15 329	0	0
7665-12 739	15.00-23.97	0-988	15 330-25 479	15.00-23.97	0-1976
12 740-52 121	23.97-42.00	989-13 989	25 480-104 303	23.97-42.00	1978-27 978
52 152-250 000	42.00	13 990-97 086	104 304-500 000	42.00	27 980-194 172
over 250 000	45.00[2]	97 086-	over 500 000	45.00[2]	194 172-

[1] Rates increase continuously over this range, not in discrete steps. The rates given in the table are exclusive of the solidarity surcharge, which is 5.5% for 2008.

[2] For individuals with a taxable income over EUR 250 000 (EUR 500 000 for a couple filing jointly) the tax rate amounts to 45%.

Tax credits

For German-resident individuals the following taxes may be credited against German income tax:

- tax withheld from salaries (wage tax), dividends and interest,
- within certain limits, foreign income tax and foreign withholding tax,
- trade tax (= 13.3% of taxable business income for trade-tax purposes, equivalent to the trade-tax base rate of 3.5% multiplied by the factor 3.8, but limited to the amount of the trade tax itself).

Solidarity surcharge

A solidarity surcharge of 5.5% on income tax is levied.

Taxation of non-residents

Unless otherwise provided by double tax treaties, non-resident individuals are subject to income tax on certain categories of income from German sources including the following:

- income from domestic agriculture and forestry
- trade or business income derived through a permanent establishment or a permanent representative in Germany
- gain from the disposal of a shareholding of at least 1% in a German company at any time during a five-year period prior to the disposal of the shares
- income from independent personal services performed or used within Germany
- income from employment performed or used within Germany
- income from investment (limited to certain types)
- rental income from German real estate and
- certain other income including gains on the sale of German real estate.

Former residents may be subject to income tax for a period of ten years after the change of their status to non-residents also with other income not listed above.

For some income categories a withholding tax is due, e.g. for income from investments, employment income, director's remuneration for members of the supervisory board, special income in connection with artistic or athletic performances or of independent writers or journalists, and special income resulting from the lease of movable goods or rights. The withholding-tax rate is in general 25% of the earnings. For artistic and athletic performances in Germany there are varying rates, beginning at zero for earnings up to EUR 250 and ending at 20% in the case of earnings over EUR 1000 (USD 1275). For income of members of a supervisory board the withholding-tax rate is 30%.

Where a non-resident has only income subject to withholding tax, he or she is in general not obliged or permitted to file an income-tax return for the year. This may be of disadvantage since filing may make the lower tax-rate for couples and the deduction of expenses available (at least where they are connected with receipts from the income categories taxable in Germany and where they actually incurred, because for non-residents lump-sum deductions are principally allowed only in the case of employment income) and may lead to a lower rate of overall tax.

To avoid the above mentioned disadvantages as far as possible some non-residents are allowed to file a tax return upon application (EU/EEA employees and under special conditions also persons with income from artistic and athletic performances or freelance writers or journalists). Alternatively, those non-residents deriving their income overwhelmingly from German sources (e.g. frontier workers), may apply to be treated in respect of their German-source income as if they were residents (see above).

Where filing a return is either necessary or permissible, the minimum rate of income tax is 25% (not including the solidarity surcharge of 5.5% also due), but may be also higher than for residents. For residents of other EU Member States, the minimum rate can only be applied where the income tax burden calculated under the minimum tax régime is lower than the income tax burden calculated under the normal German progressive income tax rates.

Church tax

Church tax (*Kirchensteuer*) is payable by individuals who are registered members of a recognised religious denomination (in Germany, these are most mainstream Christian denominations and the Judaic Religion). Church tax is charged as a percentage of income-tax liability; the rate is fixed by the state (*Land*) in which the individual resides, and is either 8% or 9%. Church tax is fully deductible in computing taxable income for the purposes of income tax.

Trade tax

Individuals in receipt of income from a business or income from independent personal services are liable to trade tax on income. See Chapter 4 for details. Trade tax is no longer deductible in computing taxable income for income tax or for trade tax itself, but for individuals, a partial credit for trade tax is available for the purposes of income tax (see above).

Compliance and returns

The German tax system is not based on self-assessment (with the exception of VAT). Individuals are instead required to file a tax return reporting their taxable income. If the return is not filed by the due date (including extensions), the tax authorities may assess the tax on an estimated amount and impose a penalty of up to 10% of the assessed tax not exceeding a maximum amount of EUR 25 000 (USD 31 975). Since taxes are based on information in the return as given by the taxpayer, there are sanctions to prevent incomplete or inaccurate returns.

To identify each individual taxpayer the Central Federal Tax Office will in 2008 be issuing a special identification number, which will be valid during the taxpayer's entire economic life.

Returns

The annual tax return for income tax and trade tax (where applicable) is due on 31 May following the end of the calendar (fiscal) year. A general extension until the end of December following the end of the calendar year is granted if a certified tax adviser, certified public accountant or a lawyer represents the taxpayer provided that no advance demand has been communicated by the tax office. A further extension until the end of February of the following year is applicable on special application by the above mentioned tax professionals. There are penalties for late filing.

Payment and collection

Income tax and trade tax chargeable in a tax assessment are due one month after the taxpayer has received the notice of assessment.

Individuals in receipt of business income are generally required to make quarterly advance payments based on the preceding year's assessment for income tax and trade tax. The advance payments have to be made as shown in Table 8:

Table 8

Income tax	Trade tax
10 March	15 February
10 June	15 May
10 September	15 August
10 December	15 November

It is possible to apply for a reduction of advance payments where a taxpayer recognises during the year that his or her income will be lower than in the previous year. If the tax finally assessed exceeds the amount of prepaid taxes, an interest charge of 0.5% per month is levied on payments made later than 15 months after the end of the respective year. If taxes have been overpaid, the same conditions will hold for interest on refunds.

Inheritance and gift tax

Inheritance and gift tax (*Erbs- und Schenkungsteuer*) is imposed on gifts *inter vivos* and on transfers on death.

If either the transferor or the transferee is resident in Germany, all property transferred (wherever situated) is subject to tax. This is also the case where either or both the transferor and/or the transferee is a German national who emigrated from Germany within the five years preceding the transfer. Where neither the transferor nor the transferee is resident in Germany and the extended rule does not apply in the case of recent emigrants, only transfers of German property will be taxed.

The tax is the liability of the transferee.

It is important to note that the Federal Constitutional Court has held the inheritance and gift tax in its current form to be unconstitutional (largely because of the favourable treatment of certain classes of property – see below). A new Inheritance and Gift Tax Act is being considered by Parliament and is expected to be enacted in 2008.

Until such time, the current Act remains in force. The text below describes the provisions of the current Act. A brief description of the anticipated changes follows.

Valuation of assets

Transferred property is valued according to the provisions of the Valuation Act (*Bewertungsgesetz*). Under this Act, business property and land in particular are ascribed a notional value much lower than their market price.

Charge to tax

Tax is charged on the increase in the transferee's estate to which the transfer gives rise. The rate of tax charged depends on both the value transferred and the degree of consanguinity between the transferor and transferee.

For this purpose, transferees are divided into three classes, as follows:

Class I: spouses, children, stepchildren, grandchildren, step-grandchildren and remoter direct descendants for all transfers, and, additionally for transfers *mortis causa*, parents, grandparents and remoter forebears

Class II: siblings and their immediate issue, sons and daughters-in-law, parents, grandparents and remoter forebears (in the case of lifetime transfers), step-parents, parents-in-law, divorced spouses (only in the event of lifetime transfers)

Class III: all other transferees and special-purpose bequests.

The current tax rates (in May 2008) are as follows:

Table 9

	Rate (%)		
Taxable transfer (EUR)	**Class I**	**Class II**	**Class III**
1 – 52 000	7	12	17
52 001 – 256 000	11	17	23
256 000 – 512 000	15	22	29
512 001 – 5 113 000	19	27	35
5 113 001 – 12 783 000	23	32	41
12 783 001 – 25 565 000	27	37	47
25 565 001 – 25 565 000	30	40	50

These bands are discrete, so that, for example, a transfer of EUR 3 million is taxed entirely at the 19%/27%/35% rate. Marginal relief is available where a transfer falls just within a higher band.

Exemptions and reliefs

Where either the transferee or transferor is resident, personal exemptions are granted as follows:

Table 10

Class I	Spouse EUR 307 000; children and stepchildren and grandchildren whose parents are no longer living: EUR 205 000; all others: EUR 51 200
Class II	EUR 10 300
Class III	EUR 5200.

Furthermore, there is an additional personal exemption of EUR 256 000 for maintenance of the surviving spouse, which is reduced by maintenance benefits not subject to estate tax.

If neither the transferor nor the transferee is resident, a personal exemption of EUR 1100 is granted.

There are also exemptions for certain classes of assets. The most important is the exemption for business assets of EUR 225 000 plus a 35% exemption of the net value of the business assets.

For more details, see *Estate Tax for Non-Residents Germany* 2008.

Likely changes

On 7 November 2006 the German Constitutional Court declared the German inheritance and gift tax to be unconstitutional. Hence, a reform of the Inheritance and Gift Tax Act became necessary, which the German Cabinet issued in draft form on 11 December 2007. This new law is likely to be enacted shortly.

In general the new Act will have effect from the date of enactment. However, to some extent the new law allows the retroactive preferential treatment of business assets. With regard to the year 2007, the draft contains an option to elect either the old or new law. This option is, however, restricted to acquisitions as a result of successions but not gifts. The following summary gives a short overview of the main modifications.

Exemptions

Regardless of the good news that the tax-exempt amounts are to be increased, the new legislation also simultaneously proposes to increase the tax rates for tax classes II and III. For taxable acquisitions up to EUR 6 million (USD 7.674 million) the tax rates are to increase to 30% and 50% thereafter.

Valuation

Up to 31 December 2006 for fiscal purposes there were different rules for valuing assets depending on the asset category. For example, the valuation method for immovable assets, business assets, and agricultural and forestry land resulted in values much lower than the fair market value. On the other hand listed securities, cash, funds etc. were valued at fair market value.

According to the Constitutional Court, this constituted a violation against the constitutionally guaranteed principle of equal treatment. Although the draft law contains different methods of valuing assets, in general all assets will be valued at fair market value (exception: the value of rented real estate will be subject to a reduction of 10%).

Transfer of business and shares

After the reform, businesses such as individual enterprises, partnerships and companies will all be valued at fair market value. However, transferees receiving a business will receive a 'bonus' if they decide to continue operating that business. Only 15% of business assets will in the first instance be liable to inheritance and gift tax. The remaining 85% of business assets will gradually be granted tax concessions over a period of 10 years, provided that the business is continued by the transferee for at least 15 years and the sum of salaries paid to employees by the enterprise does not on average fall below 70% of salaries paid at the time of transfer.

Politicians, business people and representatives of the German Chamber of Industry and Commerce have already criticised this 'long-term continuation' regulation. It is therefore likely that it will be further amended during the legislative process.

Please note that the above reliefs do not apply to passive businesses. A business is defined as passive if the share of non-trading assets (property for use of a third party, shares and bank deposits etc) exceeds 50% of the total assets of the business.

Life policies

In the past, life policies were valued at two-thirds of the policy valuation. In future, they will be valued at full valuation.

Recommended action

An asset valuation should be carried out before the new law is implemented. On the basis of this valuation one can decide if assets should be gifted before or after implementation in the summer of 2008.

6. Other taxes

Real property transfer tax

Real property transfer tax (G*runderwerbsteuer*) is imposed on the acquisition of German real property. The general rate amounts to 3.5% (4.5% where the property is situated in Berlin) of the consideration paid for the acquired real property.

Real property transfer tax is also triggered where at least 95% of the shares or interests (direct and/or indirect) in a company or a partnership owning German real property are acquired or consolidated by one taxpayer. In addition, real property transfer tax will become due if at least 95% of the interests (direct and/or indirect) in German land-owning partnerships change hands within a period of five years. In such cases, the tax will be calculated on a pre-established land value.

Property tax

Property tax (G*rundsteuer*) is an annual tax levied by local authorities on land. The tax ranges between 0.6% and 2% of the 'standard value' of the land. The standard value is much lower than market prices, approximately 65%, depending on the type of building.

7. Social security contributions

Social security system

The German social security system is based on five components:

- pension insurance
- unemployment insurance
- health insurance
- nursing care insurance and
- workers' compensation insurance.

In general, all employees working in Germany are subject to the mandatory system, regardless of their citizenship. Only employees sent to Germany for a limited period of time may be exempted.

The explanations below regarding the components of the social security system apply only for the year 2008. For future years other rates may be valid. For the eastern part of Germany the rates of pension and unemployment insurance are lower.

Pension insurance

In the year 2008 the contribution to pension insurance is 19.9% up to a maximum salary of EUR 5300 (EUR 4500 in East Germany) per month, of which the employer bears 50%. The maximum contribution payable by an employee therefore is EUR 527.35 (EUR 447.75 in East Germany) per month. Premiums are borne in equal shares by the employee and employer. All income thresholds are updated annually.

Unemployment insurance

In the year 2008 the contribution to unemployment insurance is 3.3%, up to a maximum salary of EUR 5300 (EUR 4500 in East Germany) per month, shared equally by employer and employee. Thus the maximum contribution by an employee is EUR 174.90 (EUR 148.50 in East Germany) per month.

Health insurance

In the year 2008 the average rate, caused by the deviating rates of the different health insurance providers, amounted to 13.9% based on a monthly salary up to a maximum ceiling of EUR 3600. Premiums are borne in equal shares by the employee and employer. Additionally, the employee has to pay a further 0.9% for health-care insurance.

Employees earning more than EUR 4012.50 per month may obtain coverage through a private health insurance scheme. Then they will usually be legally entitled to a tax-free reimbursement from the employer of 50% up to EUR 250.20 but not more than 50% of the actual contribution under the mandatory scheme.

Nursing care insurance

All employees must contribute to nursing care insurance, which covers care in cases of medical support which is not covered by health insurance. The monthly rate is 1.9% (before 1 July, 1.7%) up to a maximum salary of EUR 3600 and borne equally by the employee and employer. Thus an employee has to bear 0.85%. Employees earning more than EUR 4012.50 monthly may choose private insurance. Then they will usually be legally entitled to a tax-free reimbursement from the employer of 50% of the premiums up to EUR 35.10 (EUR 30.60 before 1 July) (in Saxony, max. EUR 17.10 (EUR 12.60 before 1 July)) but not more than 50% of the actual contribution under the mandatory scheme.

Workers' compensation insurance

The workers' compensation insurance is obligatory and is administered by professional associations. It covers accidents occurring in job-related activities (including accidents on the way from home to the workplace), and permanent disability caused by work. The contributions, which are borne entirely by the employer, vary with the degree of risk in a particular job, but the average contribution amounted to 1.28% in 2007.

Rates of social security contributions

Table 11 shows typical aggregate rates of contribution for both employers and employees. It is assumed that the employee is based in Western Germany and has not opted for private insurance and is earning no more than EUR 72 000 per annum (EUR 6000 per month).

Table 11

Contribution type	Contribution rate (%)	
	Employee	**Employer**
Pension insurance	9.95	9.95
Unemployment insurance	1.65	1.65
Health insurance[1]	7.85	6.95
Nursing insurance[2]	0.95	0.95
Workers' compensation insurance	0.00	varies
Total	**20.4**	**19.5+**

[1] Average rates

[2] In Saxony, the employer pays more and the employee pays less

There is no longer compulsory insurance against sickness. However, the employer is obliged to pay sick pay during the first 104 weeks at a level of 70% of the employee's salary.

Apart from health insurance, all contributions are deductible for the purposes of income tax and corporation tax.

Contributions by the self-employed

In Germany, the self-employed are not obliged to contribute to the statutory social security system. They may, however, pay on a voluntary basis, in which case they pay the combined employer and employee rate.

8. BDO Deutsche Warentreuhand

BDO Deutsche Warentreuhand AG is the BDO Member Firm in Germany. The contact details of the international tax department in the Frankfurt office are as follows:

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BDO Deutsche Warentreuhand AG and its associated firm BDO Audit and Accounting GmbH also have offices in Berlin, Bielefeld, Bonn, Bremen, Bremerhaven, Cologne, Dortmund, Dresden, Düsseldorf, Elmshorn, Erfurt, Essen, Flensburg, Freiburg, Hamburg, Hannover, Kassel, Kiel, Koblenz, Leipzig, Lübeck, Magdeburg, Munich, Rostock, Stuttgart/Leonberg, and Wiesbaden.

9. Certain BDO services

Services for your IPO

BDO Deutsche Warentreuhand AG and its associated firm BDO Audit and Accounting GmbH has considerable experience in the field of IPOs with regard to both support and consultancy. Aside from managing and coordinating the process of IPOs, we are able to assist with the following tasks.

Prior to the public offering

- elaboration of an accurate equity profile
- examination of the company's marketability
- structuring of the processes (interim financing, steps, timetables)
- tax and legal consultation in the event of a change in legal form
- conduct of financial, tax and legal due-diligence investigations
- support with the preparation of a business plan
- analysis of internal and external accounting, data processing and control with regard to the fulfilment of ongoing reporting obligations
- reorganisation of internal and external reporting in correspondence with the requirements of the stock exchange
- implementation of steering, information and risk/opportunity-management systems (KonTraG (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich* – Corporate Sector Supervision and Transparency Act), KapAEG (*Kapitalaufnahmeerleichterungsgesetz* –Capital Raising Facilitation Act))
- adoption of IFRS or US GAAP
- operations audit in accordance with capital market-oriented principles (DVFA (*Deutsche Vereinigung für Finanzanalyse und Asset Management* – Society of Investment Professionals in Germany))
- development of an issue strategy (especially issue volume and date)

During the IPO

- choice of the leading bank
- coordination of the cooperation of participating partners
- assistance in setting up a data room for the due-diligence investigation
- participation in preparing the issue prospectus and other documents
- assistance in determining issue price and placement volume
- preparation of the company for IPO reporting obligations

After the IPO

- design of investor-relations measures
- assistance in preparing the quarterly reports
- further education of employees with regard to accounting in compliance with IFRS or US GAAP
- assistance in company acquisitions

BDO in Germany is a *Deutsche Börse* Listing Partner.

Assistance to not-for-profit organisations

Owing to the consistent changes and reforms in legislation and practice relating to the NPO sector, the advisory services of professional consultants are increasingly indispensable.

BDO Deutsche Warentreuhand AG has a Competence Centre for Healthcare and the Social Economy located in Cologne, consisting of certified accountants, tax consultants, attorneys, health, and other professionals working in that branch of economic activity with decades of experience.

Double Taxation Agreements

Germany has income and capital tax treaties with the following jurisdictions:

Argentina	Israel	Romania
Australia	Italy	Russia
Austria	Ivory Coast	Serbia[2]
Azerbaijan	Jamaica	Singapore
Bangladesh	Japan	Slovakia[3]
Belarus	Kazakhstan	Slovenia
Belgium	Kenya	South Africa
Bolivia	Korea	Spain
Bosnia Herzegovina[2]	Kuwait	Sri Lanka
Bulgaria	Kyrgyzstan	Sweden
Canada	Latvia	Switzerland
China	Liberia	Tajikistan
Croatia	Lithuania	Thailand
Cyprus	Luxembourg	Trinidad & Tobago
Czech Republic[3]	Macedonia[2]	Tunisia
Denmark	Malaysia	Turkey
Ecuador	Malta	Turkmenistan[1]
Egypt	Mauritius	Ukraine
Estonia	Mexico	United Arab Emirates
Finland	Mongolia	United Kingdom
France	Morocco	United States
Georgia	Namibia	Uruguay
Greece	The Netherlands	Uzbekistan
Hungary	New Zealand	Venezuela
Iceland	Norway	Vietnam
India	Pakistan	Zambia
Indonesia	The Philippines	Zimbabwe
Iran	Poland	
Ireland	Portugal	

[1] Treaty concluded with the former USSR

[2] Traty concluded with the former Yugoslavia

[3] Treaty concluded with the former Czechoslovakia

Estate tax treaties

Germany has concluded treaties to avoid double taxation on inheritances and/or gifts with:

Denmark	Switzerland
Greece	United States
Sweden	

Social security treaties

As a member of the European Union, Germany operates the EC Social Security Regulations 1408/71 as concerns the interaction between its social security system and that of other EEA countries and Switzerland. It also has bilateral agreements with:

Australia	Israel	Serbia[1]
Bosnia Herzegovina[1]	Japan	Tunisia
Canada	Korea	Turkey
Chile	Macedonia	United States
China	Morocco	
Croatia	Québec	

[1] Treaty concluded with the former Yugoslavia

BDO *Member Firm Offices*

BDO Member Firms have offices in the following countries:

Angola	Hungary	Peru
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Bahrain	Israel	Reunion
Belgium	Italy	Romania
Bolivia	Jamaica	Russia
Botswana	Japan	Saudi Arabia
Brazil	Jersey	Senegal
British Virgin Islands	Jordan	Serbia
Bulgaria	Kazakhstan	Seychelles
Canada	Korea	Singapore
Cape Verde	Kuwait	Slovakia
Cayman Islands	Latvia	Slovenia
Chile	Lebanon	South Africa
China (PRC)	Liechtenstein	Spain
Colombia	Lithuania	Sri Lanka
Comoros	Luxembourg	Suriname
Croatia	Macau	Sweden
Cyprus	Madagascar	Switzerland
Czech Republic	Malaysia	Taiwan
Denmark	Malta	Thailand
Dominican Republic	Mauritius	Trinidad and Tobago
Ecuador	Mexico	Tunisia
Egypt	Morocco	Turkey
El Salvador	Mozambique	Turkmenistan
Estonia	Namibia	Ukraine
Fiji	Netherlands	United Arab Emirates
Finland	Netherlands Antilles	United Kingdom
France	New Zealand	United States of America
Germany	Nigeria	Uruguay
Gibraltar	Norway	Vanuatu
Greece	Oman	Venezuela
Guatemala	Panama	Vietnam
Guernsey	Pakistan	Zambia
Hong Kong	Paraguay	Zimbabwe

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