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COMPANY TAXATION

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Part I: Company Taxation in Germany

*(Pages mentioned refer to the text-book: German Tax Guide, edit. **2001**)*

A. **Financial System** (GTG 4-7):

Art. 104a-115 Grundgesetz (GG) – the Federal Constitution - states how the financial system is structured.

Legislative power:

Federation:

Exclusive power to enact legislation in the areas of:
customs and *fiscal monopolies* (tax on alcohol).

German States (= Bundesländer):

Concurrent legislation power over all remaining taxes. As long as the Federation exercises its legislative power (ESt, KSt, GewSt, ErbSt), the German states are prevented from introducing own taxes.

Municipalities (Communities):

Don`t posess their own right to pass tax legislation. They can only establish the multiplier for the “real” taxes such as *Trade Tax* and *Real Estate Tax.*

Summary: In Germany, the Federations`s legislative power to impose taxes dominates clearly.

Allocation of revenues:

Art. 106 GG states how the tax revenue is to be allocated between the federal entities.

⇒ *Federation*:

- i.g. Customs Duties; Solidarity Surcharge; Insurance Tax;
  excise taxes which are not shared with the other federal entities, such as Mineral Oil Tax, Electricity Tax, Alcohol Tax, Tobacco Tax.
- a share in Trade Tax (GewSt).

⇒ *German States (“Bundesländer”)*:

- i.g. Property tax (“Vermögensteuer” / till 1996); Motor Vehicle Tax; Real Estate Transfer Tax.
- Inheritance and Gift Tax.

⇒ *Joint Taxes*:
(Federation and German States are entitled to 50% of the revenue)
- Those taxes whose revenue shall be jointly allocated to both the Federation and the German States, such as Income Tax (ESt), Corporation Tax (KSt), and Value Added Tax (USt).

⇒ *Communities:*
- a share from ESt, USt, GewSt
  (a share of 2.2% in the revenue from USt)

Tax Equalisation among German States:

Additionally, horizontal and vertical equalisation transfer payments among the German states ("Bundesländer") with rather high and rather low revenues shall lead to an equitable allocation of taxes (see Art. 107 GG).

Horizontal equalisation = payments among the "Bundesländer".
Vertical equalisation = additional allocation by the Federation.

Tax Revenues	***2006***	***2007***	
	Billion € (= 1,000 million)	Billion € (= 1,000 million)	%
Income Tax (Einkommensteuer)	159.7	181.8	32.7
Value Added Tax (Umsatzsteuer)	146.7	169.6	30.0
Energy Tax (Energie Steuer)	39.9	38.9	8.2
Trade Tax (Gewerbesteuer)	38.4	40.1	7.9
Corporation Tax (Körperschaftsteuer)	22.9	22.9	4.7
Tabacco Tax (Tabaksteuer)	14.4	14.3	2.9
Solidarity Charge (Solidaritätszuschlag)	11.3	12.3	2.3
Property Tax (Grundsteuer)	10.4	10.7	2.1
Other Taxes (Übrige Steuern)	44.7	47.6	9.2
Total	488.4	538.2	100 %

B. **Sources** /GTG 8-12/

Tax law in general is normally founded on tax acts, ordinances and supra-national norms (Double Taxation Conventions ; EU-Law).

Tax Acts:

⇒ Come into existence by the legislative power (passing parliament)

Main tax acts: EStG, KStG, GewStG, UStG.
General Tax Act ("Abgabenordnung" AO): Regulates central tax concepts and tax definitions, procedural rules, the tax assessment, tax audits, tax offences and criminal prosecution regarding taxation.

⇒ Tax acts are binding all persons and the state.

Ordinances:

⇒ They are decreed by the executive power, although, they don`t come into existence via the formal legislative procedure.
⇒ Ordinances are binding as well! The legal status is identical with a formal tax act.

Administrative Guidelines, Circulars, Orders:

⇒ They are not statutory provisions and therefore not binding!
⇒ Issued by the Minister of Finance for the financial administration. They only bind the internal revenue service and each revenue officer.

(The idea is to support and direct the financial administration during the evaluation of tax reports and the assessment of taxes. If each tax officer would be left alone when interpreting tax provisions, the tax assessment would last much longer and could be influenced by subjective interpretation of provisions.)

Tax Court`s Decisions:

⇒ Federal Tax Court decisions ("Bundesfinanzhof = BFH") have substantial significance and are regarded as precedents (not just case material). Therefore they have widespread effects.
⇒ Administration has to adopt main court decisions in the Guidelines. These decisions influence the development of tax law interpretation.

(If there is a lack between a precedential court decision and the tax assessment in a concrete case the tax payer can file a suit against the administration. (Lower tax court in each Community and upper court: BFH).

Supranational Law (European Law and International Law):

⇒ **Supranational law ranks above national law**.

International treaties take precedent over domestic law in accordance to § 2 AO.

European Law: /GTG 10, 11/

European Law consists of primary and secondary Community Law. International treaties (i.g. EC-Treaty and other European founding treaties and protocols) constitute **primary Community Law**.
⇒ EC-Treaty:
see: Art. 5: Principle of Subsidiarity.
see: Art. 93: Harmonization of indirect taxation.
see: Art. 96, 97: Elimination of market distortions.

Secondary Community Law embraces all binding legal acts and decisions decreed by Community organs (directives, regulations) and, nonbinding acts (recommendations, opinions).

European *Directives* are binding the Member States regarding the aims to be achieved. Nevertheless they leave the choice of form and means to the legislative bodies of the States.
⇒ Parent-/Subsidiary Directive (1990)
⇒ Merger Directive (1990)

Double Taxation Conventions (DTCs) :

A DTC is an international agreement between two states (state of residence and state of source). Alongside unilateral (= national) measures, DTCs intend to avoid international double taxation by containing limitations to the contracting states with respect to their right to levy taxes by virtue of state souvereignity.

/see part II of this script: Basics of International Taxation/

C. **Major Taxes**:
⇒ Overview:
Income Tax (“Einkommensteuer - ESt”)
Corporation Tax („Körperschaftsteuer – KSt“)
Trade Tax („Gewerbesteuer – GewSt“)
Value Added Tax („Umsatzsteuer – USt“)
Solidarity Surcharge (“Solidaritätszuschlag”) and Church Tax
Inheritance and Gift Tax („Erbschaft- und Schenkungsteuer“)

D. **Income Tax / Einkommensteuer (EStG)**:

/see: GTG, p. 13-22, 79-123/

1. Principle of Residence

(a) Residents:

⇒ Residents are subject to unlimited tax liability in Germany § 1 (1) EStG (= unbeschränkte Steuerpflicht)

⇒ Worldwide Income is taxable. This principle can only be limited in a Double Taxation Convention (see Part II).

(b) Nonresidents:

⇒ Nonresidents are only subject to limited tax liability in Germany § 1 (4) EStG (= beschränkte Steuerpflicht)

⇒ Nonresidents are only taxed on their income from German sources. § 49 EStG lists exclusively the categories of income from German sources relevant for nonresident individuals.

⇒ Under limited circumstances, a nonresident individual may elect to be treated as a resident for German income tax purposes. This applies if at least 90% of his or her income in the calendar year is taxable in Germany (for more details see § 1 para. 3 and § 1a EStG).

We will only concentrate on residence taxation in a foundation course.

2. **Taxable Income** § 2 (1) to (5) EStG: */see: GTG, p. 13, 86/*

German residents are liable for tax on their worldwide income from the seven sources of income mentioned in the list below. Income in this context can be positive or negative (loss) realised in a tax year. Normally, the tax year is the calendar year. Any financial benefit to an individual that is not covered in this list is not subject to income tax, for example, gifts, bequests, lottery winnings, prizes.

Seven sources of income according to § 2 para. 1 EStG:

(1) Income from agriculture and forest economy
(2) Income from trade and business
(3) Income from independent personal services
(4) Income from Employment
(5) Income from capital investments
(6) Income from rent and leasing
(7) Other Income within the definition of § 22 EStG

= **Sum of Income (of an individual)**

⇒ **Net principle**:

In general, income is defined as **net income (= "Einkünfte")**. That means that income related expenses are deductible from gross income (= "Einnahmen"). Expenses related to a particular source of income can only be offset within that source of income. Only net income is included in the sum of income and subject to income tax.

⇒ **Two major categories of income** according to § 2 para. 2 EStG:

It is important to distinguish between two categories of income for tax purposes. Each category prescribes special **methods of determining net income**.

(a) Profit related income = "Gewinneinkünfte"). Business (net) income from sources (1), (2) or (3) is considered as profit. For these three sources, business expenses shall be deducted from gross receipts.

(b) Surplus related income from sources (4) to (7) = "Überschusseinkünfte"). The surplus of gross income above income-related expenses from sources (4) to (7) shall be determined (= „Überschuss der Einnahmen über die Werbungskosten").

The German term "Werbungskosten" (= income related expenses) only applies to surplus related income from sources (4) to (7).

Gross Income from source (1) to (7)	Revenues from sources (1 to 3)	Gross income from other sources (4 to 7)
minus: source related expenses	business expenses	Income related expenses "Werbungskosten"
= ***Net income (= Einkünfte)***	*Profits*	*Net income*

Further steps from the "sum of income" to the determination of "taxable income":

Taxable income according to § 2 para. 4 and 5 EStG:

Sum of Income (of an individual)

minus: **Personal deductions**:

(a) ***Special private expenses*** = Sonderausgaben § 10 EStG:
- alimony payments
- mandatory social contributions (to pension, medical, accident, unemployment insurance)
- church tax
- tax consultant`s fees
- certain costs related to child care, education

(b) ***Allowance for Extraordinary Hardships*** =
Außergewöhnliche Belastungen §§ 33, 33a, 33b EStG

= **Taxable Income (= zu versteuerndes Einkommen)**

„Sonderausgaben"; „Außergewöhnliche Belastungen":
/see: GTG, p. 113/

3. **Computation of positive and negative income**:

Computation of losses:

Distinguish between three kinds of methods:

(1) Off-set losses from income within each source of income (according to § 2 para. 3 EStG)
(2) Off-set losses from one source from income of other sources of income (according to § 2 para. 3 EStG)
(3) Carry back and carry forward losses (according to § 10d EStG) /see: 17, 18/

Loss Offsetting (= Verlustausgleich):

Losses from one source may be offset from income within the equivalent source (1) or from income related to another source of income (2) in a tax year.

(1)	Profit from a business (related to firm A)	=	+200
	Loss from a business (related to firm B)	=	- 50
	= Income from business and trade	=	150

(2)	Income from business and trade	=	+100
	Income from rent and leasing	=	- 100
	Sum of income		0

Beginning from year 2009*, losses from capital investments pursuant to § 20 EStG shall only be off-set within the same source of income (= income from capital investments). These losses cannot be deducted from income related to other sources anymore (see: § 20 para. 6 EStG). They can only be carried forward within the same source of income.*

Further exceptions will not be discussed in a foundation course.

Loss carry over (= Verlustabzug):

Losses shall be carried back and/or carried forward (see § 10d EStG).

This provision contains several limitations to the use of losses:

⇨ Losses exceeding the total amount of income (= Gesamtbetrag der Einkünfte) in one period shall be **carried back** to the period before (see § 10d para. 1 EStG).

⇨ The limit for carrying back losses amounts to 511.500 € per person (1,023,000 € for married persons). Losses can be carried back up to this amount as far as enough positive income is available.

⇨ Remaining losses shall be **carried forward** to the following year. The loss which can be forwarded is limited in two steps (see § 10d para. 2 EStG).

1. Step ⇨ Limit of 1 mill. €:

   Remaining losses shall be offset up to 1 mill. € total amount of income (up to 2 mill. € for married persons).

2. Step ⇨ Limit of 60 %:

   Losses exceeding 1 mill. € total amount of income shall be offset up to 60 % of the remaining total amount of income. That means that losses can only be carried forward up to this amount as far as enough positive income is available.

The tax payer can opt for the exclusive application of the loss carry forward method.

4. Important sources of income /86-112/

(a) Income from Business and Trade: § 15 EStG
(b) Income from capital investments: § 20 EStG

4.1. **Income from Business and Trade**: § 15 EStG

- Definition of business activity:

  § 15 para. 2 EStG defines a business as an independent, continued activity undertaken to make a profit that requires business relationships with third parties, which is not an agricultural, forestry, nor an independent personal service activity.

  /see: GTG, p. 88, 89/

- **Determination of profits** (§ 4 para 1, 3 and § 5 para. 1 EStG) */see: GTG, p. 609-614/*:

  - Comparison of business equity (§ 4 para. 1)
  - Comparison of business related income and expenses "Überschussrechnung" (§ 4 para. 3)
  - Profits for tax assessment in correlation with the Generally Accepted Accounting Principles – "Maßgeblichkeit des Handelsrechts" (§ 5 para. 1 EStG)

  Taxpayers who have to keep books and records and to prepare financial statements for tax purposes pursuant to §§ 140 or 141 AO and who operate a trade or business within the meaning of tax law have to determine the profit based on a comparison of business property in correlation with the ***Generally Accepted Accounting Principles*** in Germany pursuant to § 5 para. 1 EStG. This means that the tax balance sheet has to be prepared in correlation with the commercial balance sheet.But, deviations between both balance sheets may result from special tax provisions. Both balance sheets are prepared for different purposes. While the commercial accounting principles are the basis for determining the distributable profit, the tax balance sheet is prepared for calculating the amount of payable tax.

  The correlation of the commercial and the tax balance sheets applies if profits from business or trade amount to more than € 50,000 per year.

  The Generally Accepted Accounting Principles will be discussed in the course "Financial Accounting / Accounting I".

  Withdrawals from business capital ("Entnahme") have to be included in the profit determination pursuant to § 4 para. 1 sentences 1 and 2 EStG.
  /see: GTG, p. 611/

- Comparison of business related income and expenses "Überschussrechnung"

Small companies not earning more than € 50,000 per year can opt for a ***cash based*** profit determination (see § 4 para. 3). All cash outflows and inflows related to the tax year (= calendar year) shall then be computed within a certain scheme:

Cash based profit determination	*(§ 4 para. 3 EStG)*
	Business cash inflows
less	Business cash outflows
plus	Withdrawal of goods
plus	Value Added Tax received
less	Depreciation
less	Value Added Tax paid
=	Profit or loss

- **Deduction of business expenses** (§ 4 para. 4 and 5 and § 12 EStG) */see: GTG, p. 87, 90/*

⇒ Business expenses are deductible from business revenues according to § 4 para. 4 EStG.

⇒ Exception: Some business expenses are not deductible or limited for the purpose of tax accounting according to § 4 para. 5 EStG:

- deductible costs for gifts to independent business partners are limited up to € 35 per person and per year (No. 1);

- deductible costs for business dinners with independent business partners are limited up to 70 % of the reasonable price (No. 2).

- other non-deductible or limited business expenses (see § 4 para. 5 EStG); e.g.
  - entertainment expenses regarding the invitation of business partners (guesthouses, motor or sailing yachts).
  - certain costs for travelling from home to the business location (car costs).
  - penalties and fines.

- **Taxation of partnerships** (§ 15 para. 1 Nr. 2) */see: GTG, p. 208-221/*

A partnership is not an own legal entity. Only the partners are liable for debt and taxes. Therefore income is only taxed at the partner level.

Article 15 para. 1 Nr. 2 covers:

- the profit (or loss) shares of the partners in accordance with the regulations of the business contract, and
- other payments flowing from the partnership to the partners for the supply of goods or services.

All of these business related sources are determined as **income from business and trade**. This means that management fees or other payments such as interest income or rental income received by partners from their partnership are not qualified as income from employment, capital investments or from property.

The provision is based on the idea that sole proprietors and partners running a business should be treated similar. The total surplus of a business activity should therefore be reported as income from business and trade and, should be subject to *Trade Tax* (see: § 7 GewStG).

Privilege for retained earnings (since 2009):

A special tax rate of 28.25 % for business income which is not withdrawn by the partner or sole proprietor shall be applied.

4.2 Income from capital investments *after year 2008*

According to a tax reform (Unternehmensteuerreformgesetz 2008) the system of taxing dividends, interest and other income from capital has been changed!

⇨ ***Beginning from 2009 income tax for these categories is not collected by way of tax assessment anymore. Only Withholding Tax on dividends and interest will be charged, with no possibility of deducting income-related expenses. This new system is called "Abgeltungsteuer" (Withholding Tax without regular assessment).***

⇨ ***Capital gains from the sale or exchange of non-business stocks and other financial assets (in terms of § 20 para. 2 EStG) are subject to income tax in Germany since year 2009.***

⇨ ***Additionally, losses related to capital investments shall only be offset within the same source of income (see § 20 para. 6 EStG).***

4.2.1 Individuals receiving <u>private</u> income from capital → "<u>Abgeltungsteuer</u>"

Beginning from 2009 income tax for individuals who are not *involved in a business* is not collected by way of regular tax assessment anymore. Only a special withholding tax totalling 25 % will be levied (see: new § 32d para. 1 EStG). In Germany, this special charge is called "*Abgeltungsteuer*".

Beyond this special charge, the tax payer has no possibility anymore of deducting itemised expenses related to income from capital. Only the savings allowance ("Sparer-Pauschbetrag") can be offset (*see chapt. 4.2.2*).

The new system applies for *non-business* income from capital investments such as:

- <u>Dividends (see: § 20 para. 1 No. 1 EStG),</u>

- <u>Interest (see: § 20 para. 1 No. 7 EStG,</u>

- <u>Income from silent partnerships (see: § 20 para. 1 No. 4 EStG,</u>

- <u>Capital gains from the sale or exchange of assets (see: § 20 para. 2 No.1 EStG).</u>
  All capital gains from the sale or exchange of non-business stocks and other financial assets are subject to income tax in Germany since year 2009.

- <u>Other capital income according to § 20 para. 2 EStG</u>.

<u>Exceptions</u>:

"Abgeltungsteuer" will not be charged in the following cases:

- <u>dividends</u>, if the shareholder is holding at least *25 % of shares* and, if the shareholder *opts* for the regular assessment (see: § 32d para. 2 No. 3 EStG;
- <u>interest and silent income</u> paid by a corporation, if the tax payer is holding at least 10 % of shares (§ 32d para. 2 No. 1b EStG).

In these special cases only the itemised income related expenses are deductible (§ 32d para. 2 No. 3 sentence 2 EStG).

Further exceptions according to § 32d EStG will not be discussed in a foundation course.

Example: Dividends

Level: Corporation		
	Half-Income System *(till end of 2008)*	**Abgeltungsteuer** *(from 2009)*
Profit	100	100
CT (25 %)	-25	
CT (15 %)		-15
Profit after CT	75	85
Withholding Tax (20 %)	-15	
Withholding Tax (25 %)		-21.25
cash outflow	60	63.75

Level: Shareholder		
	Half-Income System *(till end of 2008)*	**Abgeltungsteuer** *(from 2009)*
cash dividend	60	63.75
gross up: Withholding Tax	15	
gross dividend	75	
Half-income-system	37.5	
taxable	37.5	
Income Tax *(top rate in 2008 = 45%)*	16.87	
deductible: *Withholding Tax*	-15	
tax payable	1.87	
IT *CT* *Total tax load*	1.87 25 26.87	21.25 15 36.25

Option:

Instead of paying this special charge ("Abgeltungsteuer"), a tax payer can apply for the normal progressive tax tariff according to § 32a para. 1 EStG if this will lead to a lower tax (see § 32d para. 6 EStG).

4.2.2 Income related expenses: deductible and non-deductible expenses:

According to the tax reform a new allowance is deductible ⇨ (in legal force since year 2009).

⇒ A **savings allowance** is deductible according to § 20 para. 9 EStG (= "Sparer-Pauschbetrag"):

- savings allowance for singles: € 801
- savings allowance for married couples: € 1,602.

⇒ Itemised income related expenses are **not** deductible anymore (see: § 20 para. 9 EStG)!

4.2.3 Income from capital received within a business → "Part-Income-System"

Beginning from 2009 the Part-Income-System ("Teileinkünfteverfahren") is applicable to capital income received by individuals or partners who are involved in a business. The tax-free part of this income amounts to 40 % (see: § 3 no. 40a EStG). Only 60 % of income from capital is therefore taxable. Correspond to this provision, only 60 % of the income related expenses are deductible (see: § 3c para. 2 EStG).

The Part-Income-System allows the deduction of income related expenses.

A comparison of the Half-Income-System and Part-Income-System:

Example: Dividends

Level: Corporation		
	Half-Income-System *(till end of 2008)*	**Part-Income-System** *(from 2009)*
Profit	100	100
CT (25 %)	-25	
CT (15 %)		-15
Profit after CT	75	85
Withholding Tax (20 %)	-15	
Withholding Tax (25 %)		-21.25
cash outflow	60	63.75

Level: Shareholder		
	Half-Income System *(till end of 2008)*	**Part-Income-System** *(from 2009)*
cash dividend	60	63.75
gross up: Withholding Tax	15	21.25
gross dividend	75	85
Half-Income-System 50%	-37.5	
Part-Income-System 60%		-34
taxable	37.5	51
Income Tax *(top rate = 42%)* *(top rate = 45%)*	15.75	22.95
deductible: *Withholding Tax*	-15	21.25
tax load (Income Tax)	0.75	1.7

4.2.4 Corporations receiving income from capital → Exemption method

According to § 8b para. 1 KStG (= Corporation Tax Act) income within the definition of § 20 para. 1 no. 1 EStG (= dividends) shall not be considered when determining the taxable income of a corporation.

Intercompany-dividends are therefore ***exempt*** from taxation. Exception: According to § 8b para. 5 KStG 5 % of the dividends which are exempt are deemed as business expenses connected with intercompany-dividends. Therefore, only 95 % of the intercompany dividend is exempt from Corporation Tax.

4.3 Income from capital investments: § 20 EStG ⇨ *scheme* ***till end of year 2008***

(Paragraph 4.3 is ***not*** *relevant for the exam !)*

Statements and definitions in this paragraph are ***not in legal force anymore***. Till the end of year 2008, the taxation of dividends was based on the "Half-Income System" /see: GTG, p. 98-101/. Withholding Tax rate on dividends totalled 20 % (till then).

The way of taxing dividends changed over time. Till year 2000 the imputation system applied in Germany. In this system, Withholding Tax on dividends was deductible from the final regular tax tariff. In the following table, the two former systems are being compared.

Comparison of the **former** imputation and **former** half-income system:

Level: Corporation		
	Imputation System	*Half-Income System*
	(till 2000)	*(2001 till 2008)*
Profits	*100*	*100*
Corporation Tax (30 % / 25 %)	*- 30*	*- 25*
Profits after Corporation Tax	*70*	*75*
Withholding Tax (25 % / 20 %)	*- 17,5*	*- 15*
Cash outflow	*52,5*	*60*

Level: Shareholder		
	Imputation System	*Half-Income System*
Cash	*52,5*	*60*
Deductible Withholding Tax	*+ 17,5*	*+ 15*
Deductible Corporation Tax	*+ 30*	*-*

	100	*75*
Tax-free (half-income)	*-*	*- 37,5*
Taxable income from capital	*100*	*37,5*

Ignoring income related expenses, tax allowances and applying the marginal top income tax rate the final tax loads amounted to:

Taxable income	*100*	*37,50*
Income Tax (51 % / 42 %)	*51*	*15,75*
Deductible Withholding Tax	*- 17,5*	*- 15*
Deductible CT	*- 30*	*-*
Income Tax	*3,5*	*0,75*

5. **Income from employment** § 19 EStG

Deductible expenses are: */see: GTG, p. 93/*

- itemised income related expenses according to § 9 EStG
  or
- a **standard tax allowance** according to § 9a No. 1a EStG
  ⇒ € 1,000 per person *(new since 2011)*

6. **Other Income within the definition of § 22 EStG**

§ 22 EStG includes a variety of taxable income, for example:

- ***short-term capital gains*** (§ 22 No. 2 EStG and § 23 EStG)

  Since 2009, this provision only covers the following items:

⇒ according to § 23 para. 1 No. 1 and 2 EStG short-term capital gains are gains from the disposition of non-business real property or personal property where the holding period was less than

(a) ten years for real property or
(b) one year for personal property (e.g. art or antique objects, precious metals).

Such gains are ordinary income, which is taxed at regular rates. A net short-term gain of less than € 600 during a calendar year is tax-free.

- recurring items of income like annuities, instalments,
- income from alimony and support, if they are deductible for the payer,

⇒ The (deductible) **allowance** for these categories of income amounts to € 102 according to § 9a Nr. 3 EStG.

7. **<u>Tax rates</u>** /see: GTG, p.113/

- General definition of scale of charges (§ 32a para. 1-3)

  ⇒ linear-progressive scale of charges

  ⇒ top rate: 45 %

- Additional solidarity surcharge: 5.5 % of the individual income tax imposed.

- Privileged tax rate for business income, income from independent personal services and income from agriculture which is not withdrawn: 28.25 %
  (see: § 34a para. 1 EStG).

- Further privilege for business income *(see § 35 EStG)*.

- Average and marginal tax rates:

  ⇒ <u>Average</u> tax rate = total income tax/taxable income

  ⇒ <u>Marginal</u> tax rate = additional income tax/additional taxable income

8. **<u>Joint assessment for spouses</u>** (§§ 26, 32a para. 5)

⇒ <u>Assessment and methods</u> /see: GTG, p. 114, 119-121/

For individuals the tax assessment period is the calendar year. Income Tax returns have to be filed by May 31 of the calendar year.

There are two ways of levying income tax:

- Income tax is normally levied by way of assessment.
- Certain income from capital investment (dividends, interest) and income from dependent personal is taxed by way of withholding tax at source.

Each taxpayer is assessed according to the amount of taxable income. For married couples there is an exception. If husband and wife are both German residents they may elect to be assessed jointly (see § 26 para. 1 EStG), in which case the income splitting system applies according to § 32a para. 5 EStG. In this case income tax is twice the amount that would be payable on half of the joint income, even when one spouse has no income.

Losses of one spouse may be offset from gains of the other spouse according to § 2 para. 3 EStG.

9. **Deductible Taxes**

Beginning from year 2009 income from capital investments pursuant to § 20 EStG is subject to Withholding Tax beyond the regular assessment ("Abgeltungsteuer"). This category of Withholding Tax is therefore not deductible from Income Tax.

But, Withholding Tax at source related to other sources of income and advance tax payments are still deductible from Income Tax according to § 36 para. 2 No. 1 and 2 EStG (= „Anrechnung“).

	Income Tax
less:	Withholding Tax (except "Abgeltungsteuer")
less:	advance payments
=	payable or refunded Income Tax

The deduction is only permitted as far as income from capital investments is not exempt from Withholding Tax. In Germany individuals and couples can instruct the bank to exempt interest, dividends and other capital income from Withholding Tax. For this purpose a special document (= "Freistellungsauftrag" according to § 44a para. 1 and 2 EStG) has to be signed and handed over to the bank. The exemption limit is related to the amount of the savings allowance (€ 801 for singles / 1,602 for married couples).

E. Corporation Tax / Körperschaftsteuer (KStG)

1. Legal forms */see: GTG, p. 125 f./*

Aktiengesellschaft (AG) = Stock Corporation
Gesellschaft mit beschränkter Haftung (GmbH) = Limited Liability Company
Genossenschaft (eG) = Cooperative

A corporation is an own legal entity. Only the business equity is liable for debt. The shareholders themselves are not personally liable for the company`s debt.

Correspond to Civil Law the corporation`s profit is subject to Corporation Tax (CT). As far as profit has been paid out, profit (= dividend) is additionally taxable on the shareholder level.

2. Residence Taxation

In case of resident corporations the worldwide income is subject to Corporation Tax (KStG) in Germany. Corporation Tax is assessed yearly.

See: chapt. D 1.

3. Taxable Income */see: GTG, p. 147-150, 159 f./*

As far as the determination of profit is concerned, Corporation Tax refers to the provisions of the Income Tax Act (§ 8 para. 1 KStG, § 4 para. 1 and § 5 EStG). All sources of income are to be categorized as income from trade and business (§ 8 para. 2 EStG).

Taxable income is derived from annual net income (profit) or net loss. Additionally, **non-deductible expenses** have to be added up according to § 10 KStG:

⇒ disallowed business expenses
according to § 4 para. 5 EStG and § 8 para. 1 KStG;
⇒ advance income tax payments (§ 10 Nr. 2 KStG);
⇒ penalties (§ 10 Nr. 3 KStG);
⇒ 50 % of payments to members of the advisory board
(§ 10 Nr. 4 KStG).

Investment subsidies pursuant to “Investitionszulagen-Gesetz” are treated as tax-exempt income. Inter-company dividends are also exempt from Corporation Tax according to § 8b para. 1 KStG.

	Determination of Taxable Income
	Net Income (Profit or loss)
plus:	disallowed business expenses - § 4 para. 5 EStG
plus:	non-deductible expenses - § 10 KStG
less :	tax-exempt income
	(investment subsidies / inter-company dividends)
=	**Taxable Income**

4. **CT rate**

⇒ CT rate: 15 %
⇒ CT rate: 25 % *(till year 2007)*

⇒ solidarity surcharge: 5.5 % of the corporation tax imposed.

5. Distributable Profit

The distribution of profit depends on the availability of Net Equity. For tax purposes the available net equity must be sub-divided into different equity baskets (see: § 27 para. 1 KStG):

	Determination of Net Equity for tax purposes “Steuerliches Eigenkapital”	
	Nominal Capital	Nennkapital = gezeichnetes Kapital
plus	Further equity contributions by shareholders	Nicht in das Nennkapital geleistete Einlagen
plus	Profit (retained and new = revenue reserve	Gewinn (Rücklagen)
=	Net Equity for tax purposes	Steuerliches Eigenkapital

Distributable equity baskets:

⇒ Nominal capital is not distributable. It cannot be paid out to the shareholders.

⇒ Distributions founded on equity **contributions** by shareholders (except nominal capital) are treated as **tax-free income** on the level of the shareholder.

⇒ Distributions founded on **profits** will result in **taxable income** from capital investments for individuals.

The amount of the distributable contribution basket at the end of a given financial year must be broken down and allocated in an independent and continuously revisable account (= „steuerliches Einlagekonto“) *see: § 27 para. 1 KStG*
. Note: This account does not include nominal capital.

Determination of Distributable Profit “Ausschüttbarer Gewinn”	
	Net Equity (for tax purposes)
less	Nominal Capital
less	Contribution Account (for tax purposes)
=	Distributable Profit

Determination of the Contribution Account for tax purposes “Steuerliches Einlagekonto”	
	Contribution Account – begin of year
less	Outflows during period (e.g. distributions)
plus	Inflows during period
=	Contribution Account – end of year

Steps regarding income distribution to shareholders *(see § 27 para. 1, sentence 3 KStG)*:

1. The distributable profit has to be paid out first. Distributable profit available at the end of a financial year has to be broken down each year.
2. In case the dividends exceed the distributable profit, the contribution account can additionally be used for a payout.

6. Loss Carry Forward and loss carry back

As far as all sources of income of a resident corporation are to be categorized as income from trade and business, losses cannot be offset against income from another category.

Only the general regulations regarding the loss-carry-forward-and-back system apply for corporations *(see chapter D 3 of this script).*

Requirement: The corporation using the loss for a setoff must be identical to the corporation that has suffered the loss.

F. Trade Tax / Gewerbesteuer (GewStG)

/see: GTG, p. 33-41/

1. **Introduction**

Trade Tax is a business tax levied on behalf of the communities. Trade Tax load is influenced by a multiplier determined by the municipals ("Hebesatz" according to § 16 GewStG). The municipals multiplier ranges from 300 % to 530 %.

According to the tax reform 2008 (Unternehmensteuerreformgesetz 2008) some provisions of the Trade Tax Act have been changed (in legal force from year 2008). Since year 2008 Trade Tax is **not** a deductible tax anymore.

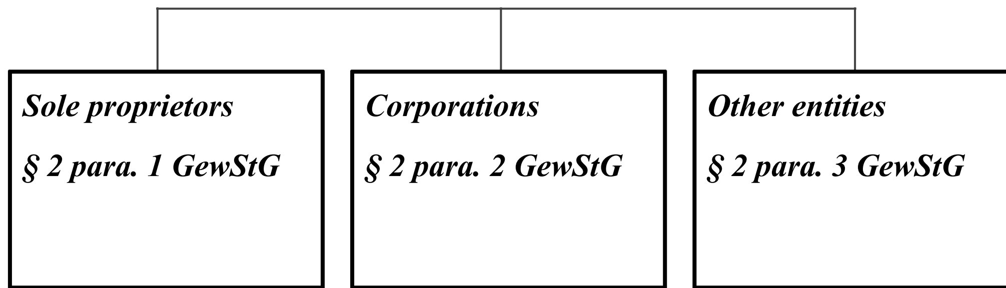
2. Taxpayer */see: GTG, p. 33/*

Taxpayers are resident or non-resident individuals, partnerships or corporations earning income from trade and business, insofar as a domestic permanent establishment is maintained.

Generally, profits from trade and business (within the meaning of income tax law) are subject to Trade Tax. Other sources of income are not subject to Trade Tax.

The following enterprises are liable for trade tax:

Enterprises earning income from business and trade



3. <u>Taxable Income (= trade income)</u>

Basis of assessment is the income from business and trade within the definition of EStG and KStG according to § 7 GewStG. This income has to be adjusted by applying special **add-backs** ("Hinzurechnungen" - § 8 GewStG) and **deductions** ("Kürzungen" - § 9 GewStG). The result of the calculation is the so-called trade income ("Gewerbeertrag").

<u>Important add-backs (+)</u>:

Add the following items as far as they have been deducted from net income:

⇒ § 8 Nr. 1 GewStG:

(a) interest or other fees for the business operation`s long-term debts***;***
(b) pensions;
(c) profit share flowing to a silent partner;
(d) one fifth of rental or leasing expenses for the usage of mobile long-term assets, which are owned by another person;
(e) 50 % of rental or leasing expenses for the usage of immobile long-term assets, which are owned by another person;
(f) one quarter of expenses paid for the usage of rights (license). See exceptions in the tax act.

Determine this add-back in <u>two steps</u>:

1. Sum up these payments and apply a **relief** ("Freibetrag") of € 100,000. In consequence, the sum is only included as far as it exceeds the amount of € 100,000.

2. **A quarter** of the remaining amount of payment must then be added.

⇒ § 8 Nr. 8 GewStG: Shares in losses from a partnership.

<u>Important deductions (-)</u>:

Deduct the following items from the sum of the add-backs and net profit:

⇒ § 9 Nr. 1 GewStG: An amount equivalent to 1.2 percent of the assessed tax value of real estate included in business property.

Explanation:

The tax value of a real estate is based on a special assessment (“Einheitswert”). The **assessed tax value** *amounts to 100 %. For determining Trade Tax this tax value has to be* *multiplied* *by:*

- *140 %, if the property is located in the old West German “Bundesländer” (see: § 121a BewG);*
- *400 %, if the business property is located in the new East German “Bundesländer” (see: § 133 BewG).*

(The assessed tax value will be given in the exam.)

⇒ § 9 Nr. 2 GewStG: Profit shares from resident or non-resident partnerships.

⇒ § 9 Nr. 2a, 7 and 8 GewStG: Generally, dividends from resident or non-resident corporations if certain requirements are fulfilled (for instance: a minimum of ***fifteen*** percent holding).

4. Multipliers

The determination of Trade Tax includes two different sorts of multipliers.

Trade income shall be multiplied with the:

(a) **trade tax multiplier** (§ 11 para. 2 GewStG):

⇒ 3.5 % in general

and additionally with the:

(b) **municipal multiplier** (“Hebesatz” - § 16 GewStG)

The municipalities apply the municipal multiplier. This special multiplier is a fixed percentage, set by resolution of the municipalities. It differs from 200 % to 490 % and is currently 410 % in Berlin and 470 % in Hamburg.

6. Trade Tax System

Income from Business and Trade (§ 7 GewStG)

plus: Add-Backs (§ 8 GewStG)
less: Deductions (§ 9 GewStG)

= Trade Income („Gewerbeertrag”)

round down to full € 100 (§ 11 para. 1 GewStG)

---

less: € 24.500 tax allowance („Freibetrag”)
for individuals and partnerships
(§ 11 para. 1 Nr. 1 GewStG)

= remaining Trade Income

---

multiply with: Trade Tax Multiplier (§ 11 Abs. 2 GewStG)

⇒ 3.5 %

= provisional trade tax (before municipal multiplier)
(= “Steuermessbetrag”)

---

apply the:

municipal multiplier
(§ 16 GewStG)

= **Trade Tax**

G. Taxation of partnerships and corporations – comparison

This comparison of tax loads considers Income Tax, Corporation Tax and Trade Tax. Additionally, special tax reliefs (see: §§ 34a and 35 EStG) which apply for partnerships are included in order to determine a comparison close to reality.

1. Taxation of partnerships

In case profit is not withdrawn, the privileged tax rate for partners totals **28,25%** (see: § 34a para. 1 EStG).

(According to the latest tax reform, this is a first step towards a unique company tax legislation which would apply for all kinds of companies independent from their legal form. The reverse provision states that a withdrawal of profit in later periods will therefore be taxed with an additional 25%.)

Offsetting Trade Tax from Income Tax ("Gewerbesteuer-Anrechnung"):

When dealing with a partnership, Trade Tax shall be offset from Income Tax on the level of each partner (see: § 35 EStG). This is a further privilege for partners.

		Till end of 2007	from 2008
1.	Profit	100,00	100,00
2.	Taxe base for Trade Tax	83,33	100,00
3.	Trade Tax (multiplier = 400 %)	16,67	14,00
4.	Income from business & trade	83,33	100,00
5.	Income Tax:		
	(§ 32c EStG: 42 %)	35,00	
	(§ 34a Abs. 1 EStG: 28,25 %)		28,25
6.	Offsetting Trade Tax		
	(§ 35 EStG):		
	(= 100 * 5% * 5/6 * 1,8)	7,50	
7.	(= 100 * 3,5% * 3,8)		13,30
8.	Income Tax (after Trade Tax)	27,50	14,95
	Solidarity Surcharge 5,5 %	1,51	0,82
9.	Total tax load (3.+7.+8.)	45,68	29,77

2. Taxation of corporations:

Level of corporation

		till end of 2007	from 2008
1.	Profit	100,00	100,00
2.	Tax base for Trade Tax	83,33	100,00
3.	Trade Tax (multiplier = 400 %)	16,67	14,00
4.	Tax base for Corporation Tax	83,33	100,00
5.	Corporation Tax (CT)		
	25 %	20,83	
	15%		15,00
6.	Solidarity Surcharge 5,5 %	1,15	0,83
7.	Total tax load (3.+5.+6.)	38,65	29,83

The low CT-rate of 15 % applies since year 2008.

Shareholder level (full pay out to shareholders)

		till end of 2008	from 2009
1.	Profit	100,00	100,00
2.	Company Tax	38,65	29,83
3.	Dividend (full payout)	61,35	70,17
4.	Taxable income:		
	- Half-Income-System	30,68	
	- „Abgeltungsteuer“ (from 2009)		70,17
5.	Income Tax		
	- 45 % (§ 32a Abs. 1 Nr. 5 EStG)	13,80	
	- 25 % (§ 32d Abs. 1 EStG)		17,54
6.	Solidarity Surcharge 5,5 %	0,76	0,96
7.	Total tax load (2.+5.+6.)	53,21	48,33

The new system of taxing private dividends (Withholding Tax without Assessment – “Abgeltungsteuer”) is considered for periods beginning from year 2009.

H. Value Added Tax / Umsatzsteuer (UStG)

/see: GTG, p. 45-62/

1. Introduction

Value Added Tax (VAT) is a transactional and general excise duty tax. VAT is an **indirect** form of taxation as the tax burden is passed on to the final consumer. However, the entrepreneur who supplies goods and services is the taxpayer.

VAT is an **all-stage-net tax system** because **input VAT** (Vorsteuer) passed on to the entrepreneur by his suppliers may generally be deducted from the entrepreneur`s **output VAT** on outgoing supplies. For this purpose, both kinds of transactions (input VAT and output VAT) have to be represented as a special account in the double entry system. While input VAT shall be entered in the books under "accounts receivable", output VAT shall be entered in the books under "accounts payable".

VAT system is based on **European Directives**. The sixth VAT Directive was issued 1977. According to the EC contract turnover taxes of the Member States shall be harmonized.

The tax revenue from VAT in Germany is close to the tax revenue from individual income tax.

2. <u>Taxable transactions</u> (§ 1 para. 1; § 3 paras. 1a and 9a UStG)

Taxable transactions according to § 1 para. 1 UStG:

Nr.1: the supply of goods and services inland for remuneration by an entrepreneur within the framework of his enterprise;

Def. (§ 3 para. 1):
The supply of goods by an entrepreneur are transactions, through which he or a third party upon his order enables the customer or a third party upon his order to dispose of an asset in his own name (transfer of power of disposition).

Def. (§ 3 para. 9):
The supply of services by an entrepreneur are transactions that do not constitute a supply of goods.

Nr.2: the importation of goods inland;

Nr.3: the intra-Community acquisition of goods inland for remuneration.

The following transactions are also **deemed as supply of goods** for remuneration pursuant to § 3 para. 1a UStG, if full or partial input tax deduction has been available to the entrepreneur regarding to respective assets or parts thereof:

⇒ the withdrawal of an asset by an entrepreneur from his enterprise for purposes outside the enterprise;

⇒ the supply of an asset by an entrepreneur to his personnel for their private use

without remuneration, except attentions;

⇒ any other supply of an asset by an entrepreneur without remuneration, except attentions.

The following transactions are **deemed as supply of services** for remuneration pursuant to § 3 para. 9a nos. 1 and 2 UStG:

⇒ the use of an asset of the enterprise by an entrepreneur for purposes outside the enterprise or for private needs of his personnel, except attentions, if the entrepreneur was entitled to a full or partial deduction of input USt regarding the asset;

⇒ the supply of other services by an entrepreneur without remuneration outside the enterprise or for the private needs of his personnel, except attentions.

3. Differentiation of territories (§ 1 paras 2, 2a and 3 UStG)

⇒ Inland: territory belonging to Federal Republic of Germany, except special duty-free areas ("Zollfreigebiete");

⇒ European Community area: Territory belonging to Member States of the European Union;

⇒ Third Country: Non-member State of the EU.

4. Entrepreneur (§ 2 UStG)

An entrepreneur is any person who engages in a trade or business or any other independent income related activity. Among these persons are: sole proprietors, independent professions, landlords, partnerships and corporations.

Intra-company supply of goods and services (for instance, to another permanent establishment) is not deemed as a taxable transaction.

Special regulation related to the supply of a **new vehicle** (§ 2a UStG):

Someone is deemed as an entrepreneur if the person supplies a new vehicle in Germany that is transported to another Member State of the European Union. The same applies if an entrepreneur supplies a new vehicle outside of his enterprise.

5. Place of supply

The supply of goods and services are subject to USt only if the place of the supply is inland.

Supply of goods:

⇒ Place of supply of **goods** (*general rule* according to § 3 para. 7 UStG):

The place of supply of goods (in general) is deemed to be **at the location of the goods** at the time of the transfer of power of disposition from the entrepreneur to the customer.

⇒ Place of supply of **goods transported or shipped** according to § 3 para. 6 UStG:

The place of supply of goods transported or shipped to the customer is deemed to be where the transportation or shipment to the customer **begins**.

Supply of services:

⇒ Place of supply of **services** according to § 3a para. 1 sentence 1 UStG:

In general, the place where services are supplied is at the **place of the business operation of the entrepreneur**. This place can be a permanent establishment of the enterprise.

Exceptions:

There are several exceptions to the general rule:

- Services related to a real estate:

  The place where services related to a real estate are supplied is deemed to be at the situs of the real estate (§ 3a para. 3 no. 1 UStG).

- Cultural, artistic, scientific educational, athletic, entertaining or similar services:

  The place of cultural, artistic, scientific educational, athletic, entertaining or similar services (including restaurant services) is where the entrepreneur performs the services (§ 3a para. 3 no. 3a and b UStG).

- The supply receiving person is an entrepreneur (§ 3a para. 2 UStG):

  The place of the supply of services is deemed to be at the place of the receiving entrepreneur`s business operation. *(This provision is in legal force since 2010.)*

Withdrawal or private use of an asset:

⇒ Place of supply in case of a withdrawal or private use of a business asset according to § 3 f UStG:

In case of the withdrawal or use of a business asset by an entrepreneur for purposes outside the enterprise or for private needs of his personnel and supply of services

without remuneration for purposes outside the enterprise or private needs the place of the supply is at the **place of the business operation of the entrepreneur**.

Other special provisions are not being discussed in a foundation course!

6. <u>Tax base</u> § 10 para. 1 and 4 UStG

Generally, the tax base of VAT is the **total remuneration less VAT** pursuant to § 10 para. 1 UStG.

Special regulation for withdrawals or private usages of assets according to § 10 para. 4 UStG:

In the case of a **withdrawal of an asset** of the enterprise (see: § 3 para. 1b) or the **private use of an asset** of the enterprise (see: § 3 para. 9a) the tax base is determined by:

• the acquisition costs less VAT (in case of a deemed supply of goods);

• the production costs (in case of self production);

• the enterprise`s cost of the services supplied (in case of a deemed supply of services).

7. <u>Tax exemptions</u> § 4 UStG

§ 4 contains a list of 28 tax-exempt transactions. Most important transactions are:

⇒ granting, procuring and administrating of loans (no. 8);

⇒ transactions covered by the Real Estate Transfer Tax Act (no. 9a);

⇒ the letting of real estate (no. 12);

⇒ the supply of goods and services by medical doctors, dentists or hospitals (no. 14, 16).

An entrepreneur may waive several of those tax-exemptions subject to further requirements pursuant to § 9 UStG *(see: topic 10).*

8. <u>Tax rates</u> § 12 UStG

Regular rate ⇒ 19 %

Reduced rate ⇒ 7 %

/see GTG: p. 59/

9. <u>Input VAT (“Vorsteuer”)</u> § 15 UStG

Input VAT may be deducted from the entrepreneur`s output VAT according to § 15 para. 1 no. 1 UStG. Input VAT must be shown separately in an invoice received by the entrepreneur that meets the formal requirements of § 14 UStG.

Definitions:

⇒ Input VAT = VAT that is paid by a business to other businesses on the supplies that it receives.

⇒ Output VAT = VAT charged by business and paid by its customer.

<u>Exceptions:</u>

Input VAT is not deductible in the cases mentioned under § 15 para. 2 UStG. Most important cases:

Input VAT on the supply of goods and services, on the importation of goods from non E.U. member states and on the intra community acquisition of goods is not deductible, if the goods and services supplied are used by the entrepreneur for:
⇒ tax-exempt supplies of goods and services (no. 1 / see: § 4 UStG);

⇒ supplies of goods and services without remuneration that would be tax-exempt if they were for a remuneration (no. 3);

⇒ supplies of goods and services outside Germany that would be tax-exempt if they were effected inland (no. 2).

Other special provisions are not being discussed in a foundation course!

10. <u>Waive of tax-exemption</u> (§ 9 UStG)
/see GTG: p. 57-59/

⇒ An entrepreneur may waive several of the tax-exemptions mentioned under § 4 UStG (*see: topic 7*).

<u>Reason for a waive</u>:

Tax-exemptions might be of disadvantage for the entrepreneur, because Input VAT may only be deducted from Output VAT as long as the goods and services supplied are **not** used

by the entrepreneur for tax-exempt supplies. Therefore an entrepreneur can opt for a waive of several tax exemptions. The waiver pursuant to § 9 UStG is often used in case of the letting of real estate, if Input VAT has been charged to the entrepreneur on construction of a building. The entrepreneur would lose the Input VAT refund, if the entrepreneur is letting the real estate free of VAT. The possible refund is being reduced pro rata temporis for every year of tax-exempt letting within a ten years period *(see: § 15a UStG)*.

Requirements for the option according to § 9 para. 1 and 2 UStG:

(Only the most important cases are being pointed out in a foundation course.)

⇒ **§ 9 para. 1 UStG:**

⇒ Tax exemptions can only be waived, if certain goods and services are **supplied to another entrepreneur for the latter`s enterprise**.

⇒ These goods and services supplied must belong to the following **categories**:

(a) the letting of **real estate** *(see: § 4 Nr. 12 UStG)*;
(b) transactions covered by the **Real Estate Transfer Act** *(⇒ buying and selling of real estates / see: § 4 No. 9 UStG);*
(c) granting, procuring and administrating of loans, administrating of security interests *(see: § 4 No. 8 UStG)*.

⇒ **§ 9 para. 2 UStG:**

In case of the letting of real estate, the tenant (“Leistungsempfänger” bzw. Mieter) is **not** allowed to use the real estate for **tax-exempt** supplies of goods and services or for non-entrepreneurial purposes.

11. Assessment

⇒ General tax assessment period is the calendar year (§ 16 para. 1 sentence 2 UStG).

⇒ Preliminary VAT return: Has to be filed for each month (“Voranmeldungszeitraum”) by the tenth day of the end of the month. Quarterly preliminary returns have to be filed instead of monthly returns, if the preceding calendar year`s VAT did not exceed € 7,500 (§ 18 para. 2 UStG).

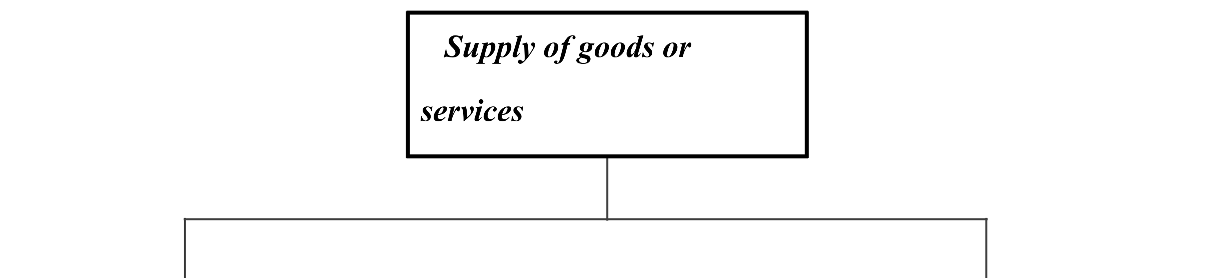
⇒ VAT will not be raised if gross sales did not exceed € 17,500 in the previous year and will presumably not exceed € 50,000 in the current year (§ 19 para. 1 UStG).

12. Special regulation for small enterprises (§ 20 UStG)

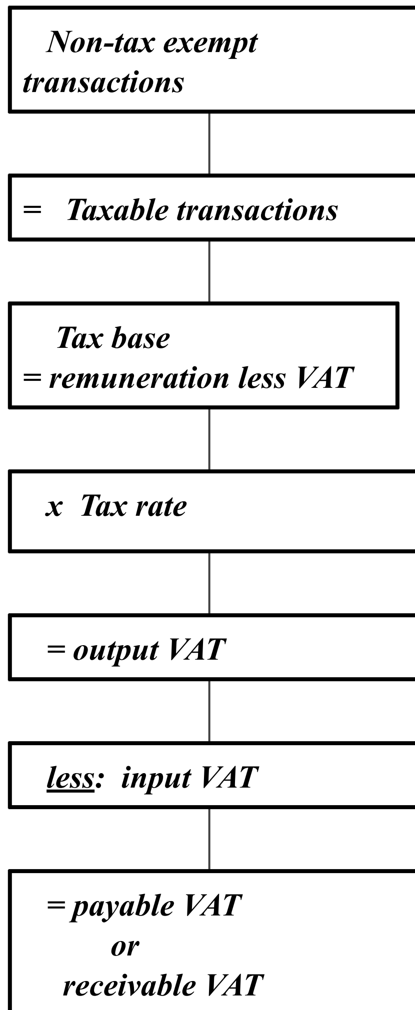
Generally, VAT is already due in the preliminary tax assessment period the supply of goods or services has occurred, irrespective of the time the price is being paid (§ 13 para. 1 no. 1a UStG).

Because this rule is of disadvantage for small enterprises, VAT is due in the preliminary tax assessment period cash has been received (§ 13 para. 1 no. 1b UStG). This applies as far as the turnover of the enterprise did not exceed € 250,000 in the previous year (§ 20 para. 1 no. 1 UStG). This limit has been increased to € 500,000 for the period from July 2009 to end of December 2011.

12. VAT system



Tax exemptions
= tax-free transactions



Part II: Basics of International Taxation

A. Double Taxation Conventions (DTC)

International tax law consists of domestic tax provisions which are spread out over several tax acts and, provisions of international treaties such as Double Taxation Conventions. All the industrialized countries possess a large number of Double Taxation Conventions.

The German network of DTCs embraces all industrialized countries and many developing countries. All countries are aiming at extending their network of DTCs.

⇒ A DTC is ranked as supranational law. They take precedence over domestic tax law (see: § 2 AO).

⇒ A DTC is a bilateral convention. Two countries agree upon a set of provisions. A multinational DTC does not exist.

⇒ The goal of a DTC is to **avoid international double taxation**.

Example:

"Super" Company, located in Hamburg receives the following income in a tax year:

Domestic Income	*200,000*
Foreign Income (from the U.S.)	*100,000*
Worldwide Income	*300,000*
Domestic tax on 300,000	*90,000*
Foreign tax on 100,000	*30,000*
Total tax	*120,000*

Resident individuals and corporations are subject to unlimited income or corporation tax. According to the principle of residence, Germany has the right to tax worldwide income. Additionally, foreign income is subject to source taxation in the foreign country (U.S.), for, non-resident individuals or corporations are subject to limited tax liability on income from German sources. As far as two countries shall tax identical parts of income (foreign income = 100,000) in one tax year related to one legal person or individual, the problem of double taxation arises.

Alongside the unilateral measures, DTCs aim at eliminating or minimizing double taxation by offering a special set of tax provisions. In the case of overlapping tax claims, a DTC consists of limitations and obligations. The most important limitations to

the contracting states with respect to their right to levy taxes by virtue of state sovereignity are related two main methods:

⇒ **Exemption method** (a state can exempt certain sources of income from taxation).

Example: Germany would then exempt foreign income from taxation.

⇒ **Credit method** (foreign state`s tax shall then be deducted from domestic tax).

Example: Germany would then tax worldwide income and credit U.S. tax. (The upper amount of the tax-credit is normally limited).

While the exemption method is privileged in German DTCs, DTCs in the U.K. and U.S. underline the credit method.

B. OECD-Model – selection of important provisions

⇒ DTCs are normally based on the **OECD-Model**

(Download from the internet!)

With respect to special interests of developing countries, some provisions of DTCs are based on the UN-Model.

1. Structure of the OECD-Model

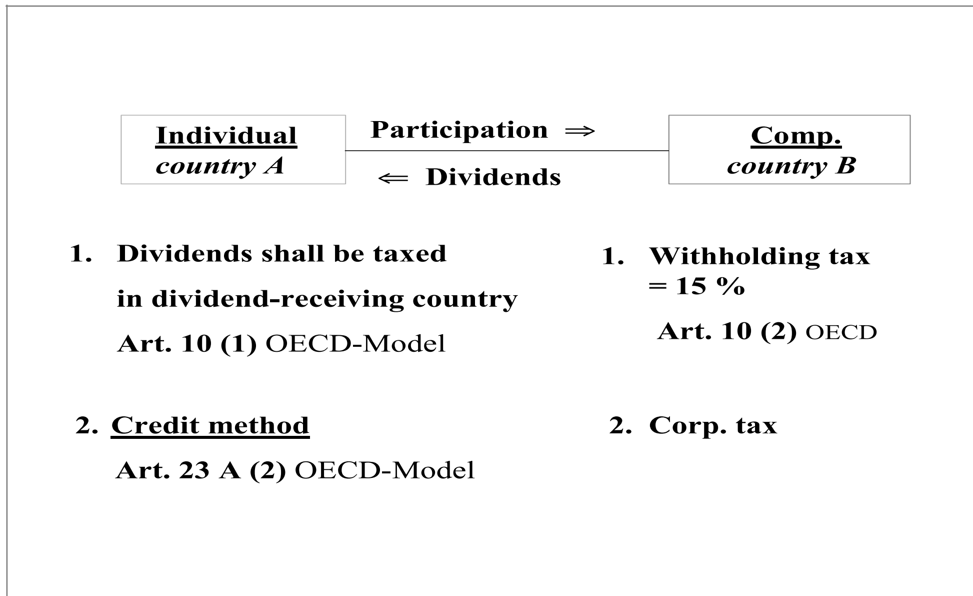
Taxes on Income:

- Income from Immovable (Real) Property (Art. 6)
- Business Profits (Art. 7)
- Shipping and Air Transport (Art. 8)
- Associated Enterprises (Art. 9)
- Dividends (Art. 10)
- Interest (Art. 11)
- Royalties (Art. 12)
- Gains (Art. 13)
- Independent Personal Services (Art. 14)
- Dependent Personal Services (Art. 15)
- Directors`Fees (Art. 16)
- Artistes and Athletes (Art. 17)
- Pensions, Anuuities, Alimony, and Child Support (Art. 18)
- Government Service; Social Security (Art. 19)
- Visiting Professors and teachers; Students and Trainees (Art. 20)
- Other Income (Art. 21)

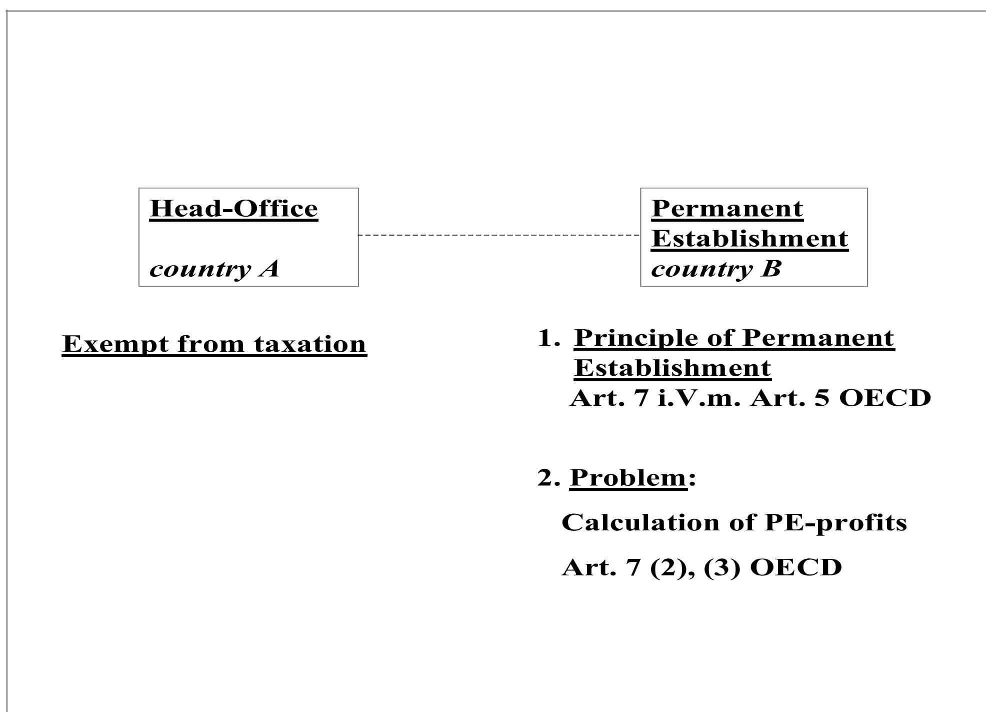
2. Special categories of income

In a foundation course we will only discuss selected provisions of the OECD-Model!

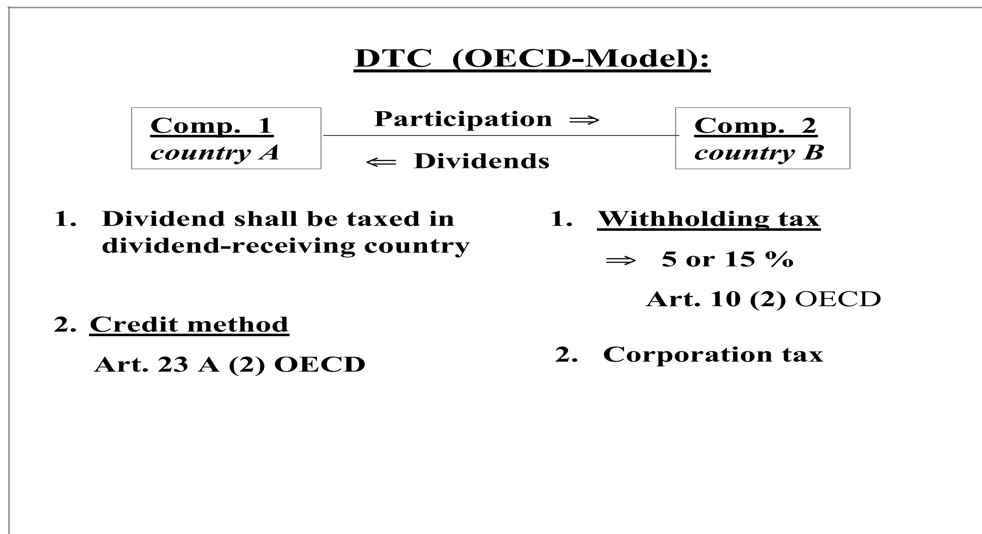
1. Individuals receiving dividends (Art. 10 OECD-Model)



2.2 Taxing foreign permanent establishments (Art. 7 OECD-Model)



2.3 Taxing intercompany dividends (Art. 10 OECD-Model)



2.4.Independent Personal Services (Art. 15 OECD-Model)

Can be discussed in the course.

Part III: Value Management and Tax Planning

The following pages are copied out of parts of an article written by Michael von Wuntsch.

Value Management and Transfer Pricing in an Integrating World – A Trend towards Convergence and Diversity. In: Andreosso-O´Callaghan, Zolin (2009), "Asia and Europe – Connections and Contrasts, Venezia.

(The whole article consists of 18 pages.)

1.**Shareholder Value Orientation and Value Management**

The creation of multi-national production networks goes hand in hand with the formation of global financial markets. Since the 1980s financial globalization has accelerated. This is due to the deregulation of domestic securities and capital markets, the liberalization of borderless financial transactions and new technologies. Together these have enabled economic activities to become global in that they can take place anywhere, anytime spanning different time zones. Not only has this intensified inter-corporate competition, it also increases competition

between different types of capital investments. Hence corporate management increasingly relies on value management.

"Creating Shareholder Value" by Rappaport represents an important contribution in the debate surrounding shareholder orientation in corporate management. In his book, Rappaport emphasizes that creating shareholder value is the prime responsibility of a market economy.

> "The idea that management's primary responsibility is to increase value has gained widespread acceptance in the United States since the publication of `Creating Shareholder Value´ in 1986. With the globalization of competition and capital markets and a tidal wave of privatizations, shareholder value rapidly is capturing the attention of executives in the United Kingdom, continental Europe, Australia, and even Japan. Over the next ten years shareholder value will more likely become *the* global standard for measuring business performance."
> Alfred Rappaport, 1998

Central to the theoretical discussion is the question of how to adequately measure performance. Accounting-based earnings and methods are inconsistent with the shareholder return objective. From an economical point of view we are dealing with a new perspective, one which is focused on increasing corporate value. Shareholders measure success in terms of increased dividend yield. The assumption is that returns are comprised of dividend pay outs and added value of a particular stock. From a shareholder's perspective added value consists of the difference between the purchase price and the realized sales price of a particular stock. The return thus represents interest on invested capital. In this model, sound financial management commences only when the interest yield of invested capital surpasses the expectations, i.e. the opportunity costs of the investor.

In value based management, yield expectations of the shareholders are the decisive comparable. The yield entitlement, in away represents the calculated rate of return of the investor. The calculated rate of return is based on the weighed average cost of capital, which consists of the cost of equity and the cost of debt. The key term 'cost of equity' contains three components[1]: base yield (risk free yield), a general market risk premium and the systematic risk (beta factor).

A corporation's weighted average cost of capital represents the standard measure for corporate investment projects. Based on this corporate point of view, if operating cash flow exceed the weighted average cost of capital, then the result is an increase in the value of the corporation. The reverse scenario would lead to a devaluation of the corporation. This point of view assumes that value based management results in efficient allocation of capital.
The objectives are clearly defined:

- Alignment of planning and controlling towards increased shareholder value;

[1] For a more detailed analysis see: Copeland, Koller, Murrin 2000: 201-232, or: von Wuntsch, Knacke, Neumann 2005: 31-34

- Explicit evaluation of strategic investment decisions with respect to development of the company value.

Within the last ten to twenty years the trend towards value-based management has gained momentum in many corporations throughout the world. This development originated in the U.S. in the 1980s and spread throughout Europe and Asia in the 1990s. In essence, we can highlight three elements:

- Increased importance of institutional investors
- Added value orientation as a protective measure against hostile takeovers
- Globalization of product markets

First: Ownership of widely held stock has changed. Institutional investors and private shareholders own widely held stocks. Even in Germany and particularly in Japan there's been a significant increase in institutional investors. Next to domestic funds, American pension funds dominate with respect to international exposure. Siemens and Veba make an excellent case in point. Between 1993 and 1999 Siemens has registered an increase in institutional investors from 15 percent to 45 percent. At Veba, this increase has jumped from one percent in 1987 to 71 percent in 1999.

Institutional investors are not tied to individual corporations when deciding on their investment options. Instead their concern is purely financial, based on rate of returns and degree of risk. According to a survey commissioned by the Deutsche Bundesbank[2] the average investment duration spans approximately one year. Competition between investment funds intensifies the pressure on corporate management. Sanctions or penalties range from under-allocation, the complete pull-out of capital all the way to rewards and incentives like over-allocation in portfolios. In their buy and sell decisions, fund managers generally pay attention to the quality of corporate governance.

Second: The danger of a hostile takeover is minimized by focusing on a corporate policy, which is based on shareholder interests. According to Alfred Rappaport, offers to acquire shares and which are directed at shareholders of the target company represent the driving force of a capital market based corporate policy (Rappaport 1998: 1). Governance of widely held stocks by institutional investors with an international focus results in greater transparency with respect to selling to hostile takers.

German managers have yet to get used to the idea to make hostile takeovers part of their modus operandi. This development came about as a result of the increased importance of institutional investors, and is accompanied and augmented by all corresponding changes. German banks[3] in particular have altered their previous strategy based on the model of supervision via large industrial concerns in favor of investment banking. Mergers and acquisitions consulting, which is a key component necessitates that banks operate more independently of industrial concerns. The late 1990s featured a steady stream of rumors pertaining to hostile takeovers of German corporations. (Veba, Beyer, Schering, Siemens,

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[2] For a more detailed analysis cf. Deutsche Bundesbank (2001, 46 *et sqq.).*

[3] For a more detailed analysis cf. Monopolkommission (1998: 102 *et sqq.).*

DaimlerChrysler, Deutsche Bank etc.). A case in point is Hoechst. Foreign shares of equity capital at Hoechst grew from 33 percent in1982 to 50 percent in 1996. During this time span, the percentage of corporations and institutional investors rose as well. By 1996, the U.S. institutional investor "The Capital Group" was already the third largest shareholder of Hoechst. Pharmaceuticals and the life sciences industry experienced consolidation and restructuring in the 1980s, a trend that intensified during the 1990s. This caused a wave of takeovers with catastrophic results for the conglomerate structure of Hoechst. When Jürgen Dormann assumed the position of managing director in 1994, he initiated a stronger shareholder based orientation. With the new focus on value added management, performance based diversification was eliminated in favor of concentrating on core business to improve earnings. In essence, diversified corporations deal with a proportionally larger danger of a hostile takeover and the danger of being traded below the sum of all its parts. That is because the larger the corporation, the larger the sum of cross subsidies for unprofitable sub entities from profitable ones. The effective market value thus is assumed to be below the sum of the potential value of all the individual subsidiaries, i.e. the conglomerate discount.

Third: Capital market orientation is especially pronounced when sectors are exposed to international product competition (Höpner 2003: 82 et sqq.*)*. Increased competition in the 1990s has significantly raised the market risk for German companies. The emphasis on shareholder orientation is a direct response to the heightened pressure of competition. The globalization of companies typically starts out with the globalization in sales. Therefore, the development of production sites abroad or the acquisition of companies operating in the target country is often related to the trend of the commodities trade. Intermediate production levels abroad including actual production may include local distribution, warehouse or service sites.

These developments also mark important institutional changes in different countries. A perspective on institutional change can be outlined and applied to Germany and Japan. We can view the German and Japanese models of capitalism as systems of incentives and constraints. In contrast to the U.K. and the U.S., neither model is considered market based in the classic liberal sense. Both Germany and Japan are headed in that direction, i.e. approaching the model of shareholder value. The control that banks exert on corporations has diminished, especially in Germany. German corporations used to be highly dependent on their main banking institution. The bank would provide financing and at the same time would also hold a stake in the corporation itself. The highly lucrative investment banking system is progressively incompatible with the German main bank based financial system. That is why German banks have relinquished their industrial shares significantly since the late 1990s. Corporations which are listed on the stock exchange have begun to be more dependent on equity investors (Vogel 2003: 317), who are more driven by the markets.

2. Impact on Value Management, Transfer Pricing and Corporate Tax Planning

We outlined that companies in countries all over the world deal with a set of institutional requirements over which they do not have complete control. Hence, in analyzing comparative institutional advantage, public policy making must be addressed as well. A good example is transfer pricing. While specific legal regulations influence the economic arena in which stakeholders compete in the market, multinational companies apply this legal framework in

order to improve their performance and to increase their value. We begin with an explanation of the strategy of transfer pricing.

The goal of minimizing tax liabilities results in a globally active corporation that compares and takes advantage of the respective tax conditions and incentives in different countries. Subsequent to our analysis, we would like to reiterate that capital-market based pressure to increase corporate value brings about a rigorous emphasis on cost efficiency. The importance of site selection based on local tax conditions and the exploitation of international taxation differences is vital to value management. Corporations more than ever base their investment and site decisions on tax rates (Wei, Andreossi-O'Callaghan, von Wuntsch 2007:164).

The strategy of the multinationals is to take advantage of their conglomerate structure. This set-up enables them to transfer profits to foreign subsidiaries with lower tax rates. This is made possible via the creation of transfer pricing for shipments and services within the conglomerate companies or corporate units. Corporate fixing of transfer pricing for miscellaneous sales offers tremendous potential for full exploitation.

Corporate strategy is clear. The value added chain is structured in such a way that companies settle in low taxation regions that earn high yields. Intra-company transfer-pricing accompanies and further augments this effect. Up-front services from a low tax region are typically priced high. The high tax country importer takes a loss and thus reduces taxable earnings and local tax liability. Proceeds accumulate in the low tax country, thus providing a great tax advantage for the conglomerate. Expert literature suggests that transfer pricing has developed into one of the most important tax strategies of transnational corporations (UNCTAD 1999:2).

Individual countries on the other hand risk losing out on significant tax revenues. Their goal is to get their fair share of the international tax revenue. If one considers that intra-company trade between conglomerates constitutes almost sixty percent of all world trade, it becomes obvious that the business model of transfer pricing currently poses a significant challenge for countries with high taxation. In response, the internal revenue services of these countries retort with a correction of transfer prices. This again exposes the transnational corporations to additional risk. In addition to the prime correction of earnings by the national tax authorities, taxable earnings are essentially double taxed. Transferred earnings in low tax countries now stand in opposition to corrected earnings in the high tax countries, effectively resulting in double taxation, a definite drawback for the corporation. Corporations need to consider this added risk factor when devising transfer pricing (von Wuntsch, Bach, Trabold 2006:248).

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