

# Doing Business in Germany

2008



## Contents

1. Introduction.....	1
2. Business environment.....	2
3. Foreign investment.....	5
4. Setting up a Business.....	6
5. Labour .....	10
6. Taxation.....	13
7. Accounting & reporting.....	26
8. UHY firms in Germany.....	30
9. UHY offices worldwide .....	30

# 1. Introduction

UHY is an international organisation providing accountancy, business management and consultancy services through financial business centres in over 70 countries throughout the world. Business partners work together through the network to conduct trans-national operations for clients as well as offering specialist knowledge and experience within their own national borders. Global specialists in various industry and market sectors are also available for consultation.

This publication is current at July 2008.

Every effort has been made to ensure that the facts in this booklet are correct at the time of going to press. However, no responsibility for loss incurred by any person acting or refraining from acting as a result of any material in this publication can be accepted.

This detailed report providing key issues and information for investors considering business operations in Germany has been provided by the office of UHY representatives:

UHY Deutschland AG  
Zimmerstraße 23  
D-10969 Berlin  
[www.UHY-Deutschland.de](http://www.UHY-Deutschland.de)

Contact : Reinhold Lauer  
[lauer@uhy-deutschland.de](mailto:lauer@uhy-deutschland.de)  
Phone : +49 30 22 65 93 55

We look forward to helping you to do business in Germany.

UHY Deutschland AG is a member of UHY, an international association of independent accounting and consultancy firms, whose organizing body is Urbach Hacker Young International Limited, a UK company. Each member of UHY is a separate and independent firm. Services described herein are provided by UHY Deutschland AG and not by Urbach Hacker Young International Limited or any other member of UHY. Neither Urbach Hacker Young International Limited nor any member of UHY has any liability for services provided by other members.

## 2. Business environment

### The German constitution and government

Germany is a parliamentary democracy with a very pronounced federal structure. The federal parliament has responsibility for national matters such as international affairs, defence and economic policy and taxation. The legislatures of the 16 federal states are responsible for issues such as education and property.

On the federal level, the most important legislative institutions are the Bundestag (federal parliament) and the Bundesrat (the upper house representing the federal states). Whilst the power of the German president is limited to representation, the position of the chancellor is fairly pronounced.

The country's constitution is based on the Basic Law that was passed in 1949. Upon reunification in 1990 its applicability was extended to the states of the ex-GDR.

German legislation is modelled on the old Roman system and has no resemblance to the Anglo-Saxon legal system.

The capital of the united Germany is Berlin. However, the main business areas are Hamburg, North-Rhine Westphalia (Cologne, Düsseldorf), Frankfurt, Stuttgart and Munich.

### The domestic market:

**Population:** 82.4 million inhabitants

**Area:** 357,093 sq. km.

**Population density:** 231 inhabitants per square kilometre.

**Currency:** Euro (EUR)

**Language:** Official language is German.

### The economy

The service sector accounted for 72% of total employment in 2005 compared to agriculture with 2.2%. Industrial production counts for 25.8%.

The total Gross Domestic Product was 2,241 billion EUR in 2005.

#### Unemployment

Unemployment figures suggest that no early improvement can be expected; the average rate of unemployment during 2007 was 9.0% (2006: 10.8%, 2005: 11.7%). In June 2008 the rate of unemployment was 7.7%.

## **Prices and interest rates**

Germany's efforts to meet the Maastricht convergence criteria for the European Monetary Union have resulted in a stabilisation of prices and a decrease in interest rates to historical lows. Since July 1, 2003 the basic interest rate has been app. 1.22%.

According to preliminary estimates the average inflation rate (consumer price index) in 2006 was 1.6% (2005: 2.0%, 2004: 1,6%, 2003: 1,1%, 2002: 1,4%, 2001: 2,0%). In June 2008 this index was 3.3%.

## **Foreign trade and the balance of payments**

German foreign trade in merchandise has shown a surplus; services and transfers produce deficits. Since the German reunification, the balance of payments has shown a consistent deficit, except in 2001 when it showed a surplus of EUR 2,651m.

## **The financial system**

Germany offers a wide range of financing options for foreign businesses investing in the country. The banking system and financial services industry are stable and well developed. The city of Frankfurt is the financial centre of Germany. It is the seat of the European Central Bank and the most important Stock Exchange of the country, and the Deutsche Terminbörse, the Options and Futures Exchange.

Financing options and banking transactions

All available banking transactions and financing options are carried out in Germany. Many forms of debt financing are available. Short-term arrangements include bank loans, trade credit from suppliers, commercial and financial paper, factoring of receivables etc.

Forms of long-term financing include open market borrowings (bonds, notes, etc) and direct borrowings (mortgages and term loans) from financial institutions. Leasing arrangements represent a further option of long-term financing.

The capital market in Germany has grown in importance over recent years. As a consequence, all major new capital instruments of financing or risk hedging such as derivatives, swaps, etc are available.

In addition, the following banking transactions can be carried out:

- deposits
- discount business
- portfolio & investment management

- guarantee business
- giro business (cashless payments and clearings)
- electronic banking.

Banking transactions in Germany are facilitated by an extensive branch network of German banks and credit institutions, as well as extensive international linkages and a sophisticated technical infrastructure.

## **Financial institutions**

The German banking industry is national, dominated by several large banks. All German banks are federally chartered. The German banking system is characterised by "universal" banks, on the one hand, and "niche" players, on the other.

The universal banks offer the full range of banking and financial services. They are dominated by internationally known names. The advantage of the universal bank system is that companies can establish long-term relationships with their respective bank, thereby avoiding the short-term view present in the Anglo-Saxon financial markets system.

The "niche" players are smaller financial institutions that have succeeded in offering specialised services.

The German financial institutions system comprises all major forms such as private credit institutions, savings banks, co-operative credit institutions, security houses, mortgage houses, trust companies, credit unions etc.

Foreign banks are permitted to establish German subsidiary operations. They tend, however, to have few branches and to focus on the business market, rather than the full-service banking market. EU legislation on bank licences has been fully implemented in Germany.

### **3. Foreign investment**

Fundamentally, there are no restrictions on foreign investment in Germany. Detailed registration regulations, for statistical purposes mainly, have to be obeyed. Considerable bureaucratic registration and permit regulations for each individual case have to be considered, too. Foreign investment has decreased considerably in the last few years.

After years of reluctance in private investment, the expected positive development of the economy should provide new opportunities for investment.

## 4. Setting up a Business

For foreign investors there are two main forms of business organisation in Germany:

- The legally non-independent branch of a foreign company.
- The legally independent subsidiary.

The definition of a legally independent subsidiary is influenced by fiscal legislation and is briefly discussed below.

Numerous forms of organisation and structure are available to foreigners setting up businesses in Germany. German Commercial Law distinguishes between unincorporated firms and corporations. The legal structure should be chosen in dependence to the degree the investor wants to be liable to creditors. A corporation is a legal entity in itself and is, hence, liable only to the extent of its capital contribution. In the case of the unincorporated company, at least one of the partners has unlimited liability for the firm's debts.

The following sections deal only with the commonly used and most widespread forms of business organisation.

### Unincorporated companies

#### Sole proprietorship

This is the simplest form of organisation. The business is carried out by a sole proprietor. There are few formal filing and reporting requirements, other than maintaining proper records and obtaining the necessary local permits.

The sole proprietorship is not a legal entity apart from its owner, i.e. the proprietor is subject to unlimited personal liability for claims against the business. The proprietor himself is subject to taxation and needs to be entered in the commercial register.

This form of business organisation is commonly used for small enterprises and operations.

#### General partnership (Offene Handelsgesellschaft = OHG)

A general partnership is an entity formed for the purpose of conducting a specific business endeavour, which is owned by two or more partners. The partners each contribute capital and effort, and share profits in some agreed-upon way. Each partner retains unlimited liability.

### **Limited partnership (Kommanditgesellschaft = KG)**

The limited partnership represents a company structure that distributes the liability risk differently among the partners. This legal form is particularly common among family-owned small and medium-sized enterprises.

In a limited partnership, there are two kinds of partners. One or more "general partners" run the company and have unlimited liability, while the role of the "limited partners" is restricted to the contribution of capital, i.e. they do not participate in the management. In contrast to the general partner, the limited partners' liability extends only to the amount of capital they have invested.

GmbH & Co. KG - a special case of the limited partnership

The GmbH & Co. KG is a form of business organisation unique to Germany. Its main characteristics are as follows:

The limited liability corporation (GmbH) is the general partner of the limited partnership (KG). The corporation assumes an administrative role and is generally provided with its minimum legal capital. The limited partnership (KG), on the other hand, owns the company's assets and runs the actual business. The management and the power of representation to third parties come under the control of the general partner, i.e. the limited liability corporation.

### **Silent partnership (Stille Gesellschaft)**

The silent partnership is a form of business organisation with a focus on the "internal" structure of the enterprise. The participation of the silent partner in any kind of company is effected through a capital contribution which is then transferred to the assets of the owner of the company. As a result, no joint assets are formed between the silent partner and the owner of the enterprise. The contribution of the silent partner can be considered a simple investment. It is essentially very similar to the contribution to a limited partnership.

A distinct feature of the silent partnership is that its equity structure, i.e. the contribution of the silent partner, is not perceivable externally.

Civil-code partnership (Gesellschaft bürgerlichen Rechts = GbR)

The civil-code partnership is an entity formed for any kind of business, commonly for small entrepreneurs. It is based on a contract of association between two or more partners in pursuit of a common purpose. Each partner has unrestricted personal liability. This form of business organisation is common for small entrepreneurs, the self-employed, as well as for temporary projects of larger enterprises or joint ventures (e.g. large construction projects).

The civil-code partnership is not entered in the commercial register.

### **Professional partnership (Partnerschaftsgesellschaft)**

On July 1, 1995, a new legal form was introduced: the Professional partnership is open only to the liberal professions. Professionals within the meaning of this law are, e.g. physicians, architects, engineers, management consultants, artists, lawyers, auditors etc.

European Economic Community of Interests (Europäische Wirtschaftliche Interessenvereinigung = EWIV)

The Europäische Wirtschaftliche Interessenvereinigung (EWIV) exists as a legal form of a company under European law.

The formation of this company requires a contract and at least two members belonging to different member states of the EC. These members may be legal persons under public law as well as under private law.

## **Corporations**

A corporation is a legal entity distinct from the individuals who own it. It protects the assets of its owners through limited liability of shareholders, and generally offers investors easier access to capital and financing opportunities than an unincorporated venture. The costs of setting up and maintaining a corporation are, on the other hand, higher than those of partnerships or proprietorships. In addition, corporations are subject to more rigid government legislation and information requirements.

German corporations can be either privately or publicly owned. Private corporations cannot sell shares to the general public. Public corporations need to fulfil numerous disclosure and reporting requirements and must file prospectuses with the relevant securities commission before offering shares to the public.

### **Stock corporation (Aktiengesellschaft = AG)**

In economic terms the full public company is not necessarily the most important form of business organisation in Germany.

The full public company may either be quoted on one of the German stock exchanges, of which Frankfurt is the dominant trading place in the country, or be held as long-term participations without being quoted. Shares can easily be transferred through contracts of sale. In contrast to the sale of shares in a limited liability company, the sale of shares of a public company does not need to be certified by a notary.

**Limited liability company  
(Gesellschaft mit beschränkter Haftung = GmbH)**

This form of business organisation is particularly suited to medium-sized companies and indeed represents the preferred form for the so called German "Mittelstand", as well as for subsidiaries of foreign companies in Germany. It is particularly suited to family-owned and owner-managed businesses.

**Real Estate Investment Trust**

Effective from 1 January 2007, Germany introduced the real estate investment trust (REIT), which is a tax-exempt entity. In general, a REIT is a listed German stock corporation (AG) that satisfies all of the following conditions:

- It has a free float (volume of shares traded on the stock exchange) at the time of listing at least 25%;
- Its real estate assets account at least for 75% of its gross assets;
- Rental income from real estate accounts at least for 75% of its total income; and
- Ninety percent of its income is distributed to its shareholders.

## 5. Labour

### Employment contracts

The employment contract forms the basis of the relationship between employee and employer. The terms of the contract can be freely negotiated by both parties subject to existing legislation, industrial wage agreements and operational agreements.

In addition to the terms of the individual employment contract, the following laws and agreements apply to any employee:

- collective agreements
- agreements between the management and work councils of any one company struck in the framework of co-determination (Industrial Constitution Law)
- labour protection laws such as:
  - i. working-time ordinance
  - ii. continued pay in case of sickness
  - iii. employment security
  - iv. laws relating to severely disabled
  - v. health and safety regulations
  - vi. maternity leave
  - vii. regulations on youth employment
  - viii. statutory holidays
  - ix. German Equal Treatment Act (AGG)

German employees are historically grouped into blue-collar workers, white-collar workers and apprentices. This classification has consequences in terms of dismissal protection.

Employees in managerial positions do not fall under the Industrial Constitution Law and have a special status in legal terms.

### Organised labour and wage settlements

According to Basic Law, employer associations and trade unions are able to negotiate wage settlements and working conditions among themselves without interference from government bodies. The German system is very

much based on the notion of "social partners". Wage bargaining represents a collective process during which working conditions and wage settlements are negotiated for entire occupational groups in various industries. Both members of the employer associations, as well as trade unionists, are bound by the outcome of their collective bargaining. Non-organised employees usually receive the same wage and working conditions as their organised counterparts, although the employers are not obliged to grant the same terms and conditions as for the organised.

## Social security

Social security coverage in Germany is statutory for a large part of the population. The compulsory insurance plan serves to protect people from hardships due to sickness, work-related accidents, general disability and unemployment.

Moreover, statutory pension insurance is compulsory for employees.

Social insurance is a traditional must for employees. In this context, employees are typically regarded as persons in dependent employment who, due to their dependence upon their employer, need social security. The development in the labour market in recent years produced numerous groups of gainfully employed people (highly qualified/less qualified casual workers, etc) who cannot be easily insured under the traditional social insurance system.

The present system stems from legislation dating back to the late 19th century and early 20th century, which was introduced in response to the industrialisation process and the corresponding growth of the working class population. A compulsory health insurance plan was introduced as early as 1883. This was followed in 1884 by work-related injury coverage and various pension insurance plans. In 1927 the unemployment insurance was introduced. The latest addition to the social security system was the so-called nursing insurance plan introduced in 1995.

## Rates

### Social security contribution rates for 2008

	rate %
health insurance (average)	14.25
nursing insurance	1.95
pension insurance	19.9

unemployment insurance 6.6

**Income thresholds (upper limit) for 2008**

	<b>Old federal states EUR pa.</b>	<b>New federal states EUR pa.</b>
health & nursing insurance	43,200	43,200
pension insurance	63,600	54,000

## 6. Taxation

The taxation of commercial activities in Germany depends on the particular form of business organisation chosen. The main aspect to be considered in this context is that the income and net worth of unincorporated companies are taxed at the level of the individual partner, while a corporation represents an independently taxable entity.

For general information on taxation please see:

<http://www.bundesfinanzministerium.de>

### Unincorporated companies and individuals

#### Income taxation

#### Liability to pay taxes

Partnerships – such as OHG, KG, GbR, partnership company – and sole proprietorships are not separate legal entities but associations of partners, with the partners themselves generally being subject to all rights and obligations. Accordingly, partnerships are not subject to corporate income tax but to personal income tax with the individual tax rate applicable to each shareholder. Therefore, only individuals are subject to income tax. Legislation distinguishes between a limited and unlimited liability to pay taxes.

However, in order to achieve a tax burden neutrality between partnerships and corporations, the personal income tax rate applicable to retained earnings (thesaurierte Gewinne) of a partnership is now limited to 29.8% - 28.25% plus solidarity surcharge. After offsetting personal income tax against trade tax payments, retained earnings of a partnership will therefore be subject to an average tax burden similar to that of a corporation under the corporate income tax. After distribution to the partners, the distributed earnings are subject to a subsequent taxation of 25%, provided and insofar as the annual balance between a partner's capital contribution and withdrawals exceeds the annual profits of the company or the partner's share in the company ("excess withdrawals"). The overall tax burden on distributed earnings therefore adds up to app. 47.7% corresponding to the distributed dividends of the corporation.

The basic principle of German taxation is that an individual may be charged tax on his worldwide income if he is a resident of Germany. If the individual is not a resident he will still be liable for tax on income earned in Germany but not for tax on income which arises abroad.

Germany has entered into a large number of agreements for the avoidance of double taxation with other countries. Most treaties make provisions for the situation that an individual is resident in two different countries.

The terms of agreements for the avoidance of double taxation override German tax law and, if an individual is deemed to be a resident of a foreign country under the agreement, his German tax liability will then be computed in accordance with other provisions of the agreements for the avoidance of double taxation treaty.

### **Taxable income**

Taxable income comprises the entire annual income from the following sources:

- Agriculture & forestry
- Business establishments (trade)
- Self-employment
- Employment
- Interest & dividends
- Land & property
- Other income

Income tax is computed on a progressive scale. German legislation allows for the deduction of certain expenses that are economically linked with the various sources of income. Relief can be granted for itemised expenses. In some cases relief can be granted on the basis of standard allowances.

Income of business establishments or trade is taxed on the basis of their net profits. Especially smaller firms calculate this on the basis of a uniform balance sheet for tax and commercial purposes.

### **Tax rates**

In 2008 individuals are subject to federal rates of taxation as follows:

	single EUR	married EUR	tax %	rate
Basic personal allowance	7,664	15,328	0	
Progressive rates of	7,665-52,152	15,330-104,304	15.0-42.0	
Tax rate as of	52,153-255,000	104,305-500,001	42.0	
Highest tax rate as of	250,001	500,002	45.0	

### **Reduction of income tax by the Tax Reform 2005 / Top tax rate changed by the Tax Reform 2007**

As from January 1, 2005 the basic tax rate is reduced to 15% while the top rate was cut to 42%. Due to the German Tax Reform 2007 the top rate increased to 45% and will be applied only to taxable income in excess of EUR 250,000 respectively 500,000.

In addition to the afore-mentioned income tax, a Solidarity Surcharge (Solidaritatzuschlag) of currently 5.5 % of the income tax is levied.

Taxes on income from employment are based on the employee's monthly salary (PAYE). It is the employer's duty to deduct tax and to forward it to the fiscal authorities. At the end of the year the tax amount withheld throughout the year will be certified on the employee's wage tax card in order to be taken into account in the final income tax assessment.

### **Trade taxation**

Trade tax is collected by the municipalities, which have a degree of discretion on fixing the rate on this income tax. The system of computation is fairly complicated but the average tax rate is app. 14%. If a firm has permanent establishments spread over several municipalities, the tax will be distributed amongst the municipalities according to a key based on the size of the payroll.

Trade tax can be deducted as a business expense for the purpose of calculating its own tax basis and the tax basis of income and corporation tax only until the end of 2007. Due to the 2008 Business Tax Reform trade tax has to be considered as a non deductible tax expense as of 2008 onwards. However, a part of the trade tax can be deducted from the personal net annual income tax payment.

The basis for trade tax computation is a modified income. That means some expenses that can be deducted for income tax purposes are non-deductible for trade tax purposes. These amendments were also be adjusted by the 2008 Business Tax Reform. The major adjustments include a 25% add-back of interest on long-term debt, a 25% add-back of lease payments for movable assets and a 75% add-back of lease payments for immovable assets. Furthermore under the 2008 Business Tax Reform, the base rate imposed by the trade tax law (to which a multiplier set by the municipality is applied) is reduced from 5% to 3.5%. The municipalities may not increase their local multiplier. As a result, the effective average tax rate is lowered from about 18% to 14%. Moreover, the option to offset trade tax payments against personal income tax will be improved considerably. Previously, partnerships and sole proprietorships could offset trade tax payments against their personal income tax burden with a

weighting factor of 1.8. Under the reform of company taxation, this weighting factor has been more than doubled to 3.8. Accordingly, the personal income tax of a partnership or sole proprietorship can be reduced by 3.8 times the trade tax base amount.

All commercial firms are subject to trade tax, whereby the administration of assets is not considered as a commercial activity. Trade losses can be carried forward without limitations in time. An amount of EUR 24.500 is exempt from trade tax for individuals, sole proprietorships and partnerships.

### Example – Unincorporated companies

Taxable income before income:		1,000,000	1,000,000
Amount of deduction:		<u>-24,500</u>	
<i>(amount of exemption: 24.500)</i>		<u>975,500</u>	
Trade tax ( <i>i.e. Cologne, collection rate:</i>	450%	<u>-153,641</u>	-153,641
<i>after amount of exemption)</i>		821,859	
Income tax (45% on EUR 821,859)		369,836	
Deduction for trade income acc. to para § 35 EStG base value for tax purposes	34.143		
3,8-times		<u>-129,742</u>	
		<u>240,095</u>	
Solidarity surcharge	5,50%	13,205	
Total tax		253,300	<u>-250,000</u>
<b>Net income</b>			<b>593,059</b>

### Corporations

#### Corporate income taxation

Due to increasing international economic links and capital interdependence, the importance attached to issues dealing with taxation of corporate profits has increased. Most industrial nations have been trying to reduce or to eliminate the double economic burden of profit distributions imposed on the corporation and on shareholders.

The corporate tax rate has been cut to a uniform 25% since 2001. Due to flooding in East Germany in 2002 the tax rate was 26.5% only in 2003. Since 2008 the corporate income tax is payable at a rate of 15% of taxable income, regardless whether the income is distributed or not.

A 5.5% surcharge is imposed on the corporate income tax, resulting in an effective tax rate of 15.825% (before the 2008 Business Tax Reform, the rate was 26.375%). Prepayments of corporate income tax and withholding tax payments are also subject to this surcharge.

Companies that continue to have a corporation income tax credit balance resulting from retained earnings taxed in the years for which the imputation tax credit system applied (1999 and earlier years) will receive a refund of such remaining balance in 10 equal amounts during the period of 2008 through 2017. Vice versa these effect concerns the basket 2 amount. 3% of the basket amount leads to additional tax payments also in 10 equal amounts during the period of 2008 trough 2017.

The basis for calculating corporation tax is the profit of the corporation. There can be differences between the commercial and taxable profit of the corporation.

As regards to the taxation of dividends, the so-called imputation system was applicable in 2001 for the last time. However, there are still some effects for companies in existence at the end of 2001. From 2002 the imputation system has been replaced by the "half-income-system". Under this system, only half of the distributed profits of a corporation are included in the shareholder's personal income tax base. In return, it is no longer possible to credit the corporation tax paid by the company against the shareholder's income tax. On the other hand, shareholder expenses related to distributed profits are deductible by no more than 50%, if the shareholder is an individual. This rule applies also for shareholders' interest payments. Irrespective of the half-income taxation method withhold taxes are retained at non-resident tax liability.

Due to the 2008 Business Tax Reform from 2009 onwards the "half-income-tax-system" was replaced by a "partial-income-procedure". As of 2009, dividends will be exempted to the extent of only 40 percent instead of, as currently, to the extent of 50 percent. Correspondingly 60% of the shareholder expenses related to distributed profits are deductible.

Dividends received by German companies and branches of non-resident companies from their German and foreign subsidiaries are exempt from tax. This results from the introduction of a participation exemption (comparable to a full dividend-received deduction) for all intracorporate domestic of foreign dividends. The law imposes neither a minimum shareholding requirement nor a minimum holding period requirement for the participation exemption. The exemptions described above are

contained in the domestic tax code. However, an applicable tax treaty may also provide an exemption for foreign dividends. Five percent of the tax exempt dividend income received from foreign subsidiaries is treated as a non-deductible expense, while the expense actually accrued are deductible. For dividend income received in tax years ending after 31 December 2003, the 95% exemption rule applies to dividend received from both resident and non-resident corporations. Expenses related to such income are fully deductible for corporate tax purposes. This also applies to non-resident corporate sellers that owned at least 1% of the capital stock of a German company at any time during the five years preceding the sale, if the foreign seller cannot claim treaty protection.

To the extent that write downs of shares have previously been deducted, normal income taxes imposed on sales of these shares. If the shares were acquired through a tax-free contribution of a business or division of a business in exchange for shares, a seven-year holding period is required for the exemption. For capital gains derived from sales of shares that were acquired in a tax-free share-for-share exchange, the exemption does not apply if the shares were acquired in a tax-free contribution of a business or division of a business and if the seven-year holding period has not expired.

To prevent certain abuses, a German corporation that receives shares below fair market value through an individual's contribution to capital is subject to tax on capital gains derived from sales of such shares within seven years after date of the contribution.

As explained capital losses are in general deductible. However, capital losses are not deductible if a gain resulting from such transaction would have been exempt from tax. In particular, this rule applies to capital losses from the sale of shares or from write downs on shares. In addition, capital losses and write-downs on loans to related parties may not be deductible under certain circumstances.

Dividends received from corporations in which the parent holds less than 10% at the beginning of its fiscal year are subject to trade tax. The same rule applies to dividends received from non-EU corporations, regardless of the percentage of ownership, if passive income accounts for more than 10% of the foreign corporation's gross income.

Private shareholders can sell their stakes in corporations after a minimum holding period of one year without paying tax, as before, unless they have a substantial interest in the corporation. However, the threshold for what constitutes a substantial interest was reduced from 10% to 1% from the 2002 tax year. If the sale is subject to tax - i.e., when shares are sold within the one-year holding period or represent a substantial interest – the half-income method applies from 2002 until 2008. From 2009 onwards due to the 2008 Business Tax Reform 100% of all kind of dividends, capital gains (e.g. interests, dividends, investment, certificates) and speculation gains (e.g. securities, investment shares, participations in corporations, and others, excepting real estate) will be subject to tax to a new 25% compensation tax. Shareholders with an individual personal income tax rate of less than 25% can request that their individual tax rate to be applied.

### **General Interest Limitation**

The general interest limitation has replaced the former thin-capitalization rules. Due to the 2008 Business Tax Reform a new concept for the restriction of the interest deduction was introduced. This restriction applies regardless whether the interest is paid to a related party or an unrelated lender, such as a bank. The new rule, which is effective for the tax years beginning after 25 May 2007 and ending on after 1 January 2008, applies to companies resident in Germany, companies abroad but maintaining a permanent establishment in Germany and partnerships with a German brand.

The new rule disallows “excess net interest expense”, which is defined as the excess of interest expenses over interest income if such excess exceeds 30% of the earnings before (net) interest, tax, depreciation and amortization (EBITDA). The limitation rule does not apply if any of the following conditions is satisfied:

- The net interest expense is less than EUR 1 million;
- The company is not a member of a consolidated group (a group of companies that can be consolidated under International Financial Reporting Standards [IFRS]); or
- The equity ratio of the German subgroup is equal to or higher than the equity ratio for the group as a whole, as shown on the balance sheet of the preceding fiscal year (so-called “escape clause”). A “group” is defined as a group of entities that could be considered under IFRS, regardless of whether a consolidation has been actually carried out. The escape clause does not apply if any entity in the worldwide group has received loans from a related party not

included in the group and if the interest paid on such debt exceeds 10% of the net interest expense.

### **Trade taxation**

The rules and regulations applicable to the computation of trade tax for corporations correspond to those applicable to unincorporated businesses. A tax exempt amount is not applicable to the profits of corporations.

### **Withholding tax on capital yields**

The German withholding tax on capital yields is levied as a source tax that needs to be retained by the debtor and remitted to the fiscal authorities, i.e. the beneficiary receives only the net amount. The withholding tax, or capital gain tax, is a subcategory of personal income tax. It functions as an advance payment on the tax due for interest on a financial investment or on shareholder dividends. If a bank pays out capital gains, such as interest on a financial investment or on dividends from stock options, the bank must withhold the tax and transfer it to the tax authorities. The payment is then offset against the personal income tax.

The standard rate of withholding is between 20 and 30%, but the rate may be reduced for certain countries by treaties for the avoidance of double taxation and under the EU Parent-Subsidiary Directive, which has been incorporated into the German Tax Code (Section 43b). Where a double taxation agreement stipulates a lower withholding tax than the one applicable in Germany, the foreign shareholder can either

- file an application at the federal Central Tax Office for reimbursement of the withholding tax paid in excess, or
- apply for an advance exemption from the excess share of withholding tax (this option is only available to corporations).

The Federal Republic of Germany has concluded bilateral agreements with over 90 states. A list of these countries can be found on the homepage of the Federal Central Tax Office:

- [http://www.steuerliches-info-center.de/de/003\\_menu\\_links/002\\_ISt/008\\_internRecht/index.php](http://www.steuerliches-info-center.de/de/003_menu_links/002_ISt/008_internRecht/index.php)

The 2007 Annual Tax Act tightened the domestic antiavoidance rules (Section 50d III ITA). It denies benefits under the treaties or an EU

directive for a foreign recipient of dividends, interest or royalties, if any of the following circumstances exist:

- The parent company of the recipient would not been titled to an equal treaty benefit had it received the income directly and the interposition of the intermediate holding company cannot be justified by good business reasons;
- The foreign recipient of the income does not derive at least 10% of its gross income from its own trading operations; or
- The foreign recipient does not participate in the general commerce with fully equipped business facilities.

### **Tax deductions related to limited tax liability**

Payments of certain amounts to non-residents are subject to withholding tax. These include payments such as

- Royalties and license fees
- Interest
- Dividends
- Management fees.

### **Example (for 2008)**

	EUR	EUR
<b>Corporation</b>		
Taxable profit before tax (i.e. Cologne)		1,000,000
Trade tax (net)		<u>157,500</u>
		842,500
Corporation tax 25%	150,000	
Solidarity surcharge 5.5%	<u>8,250</u>	<u>158,250</u>
Net income		<u>684,250</u>

### Shareholder

Gross profit distribution (dividend):		<u>684,250</u>
Withholding tax (20%)		<u>136,850</u>
Solidarity surcharge (5.5%)		<u>7,527</u>
Taxable income (1/2 of the gross dividend)		<u>342,125</u>
	Income tax	Solidarity
	<u>45.0%</u>	<u>(5.5%)</u>
Income tax for residents	153,956	8,468
Withholding tax	<u>136,850</u>	<u>7,527</u>
Final payment	<u>17,106</u>	<u>941</u>

## Comparison: Incorporated and Unincorporated companies

	<u>corporation</u>	<u>Unincorporated companies:</u>
Profit before tax	1,000,000	1,000,000
Trade tax	157,500	153,641
Corporation tax + solidarity surcharge	158,250	-
Income tax + solidarity surcharge in case of full distribution	<u>162,424</u>	<u>253,300</u>
Net income	<u>521,826</u>	<u>593,059</u>

### Taxation of permanent establishments in Germany

According to German tax laws, a permanent establishment is defined as an operational facility (representation office, plant, sales office, etc.) that serves to carry out business activities in Germany.

Commercial activities include all sorts of business transactions that go beyond the mere preparation of business contacts or other auxiliary services. The permanent establishment has its own internal organisation and bookkeeping and could, therefore, exist as an independent commercial entity without major restructuring efforts.

Because there are different national definitions of the term "permanent establishment", the tax committee of the Organisation for Economic Co-operation and Development (OECD) has come up with a uniform definition (*cf. article 5 OECD sample convention*).

The right of taxation is usually regulated by means of Treaties for the Avoidance of Double Taxation between Germany and the other country. In most cases taxation takes place in Germany in line with the international principle of place of operations. The other country, therefore, does not levy taxes on the profits of the permanent establishments.

If the foreign parent company is an unincorporated partnership, then the profits of the permanent establishment located in Germany are usually subject to German income tax.

The profits are, as a consequence, exempt from further taxation in the country of domicile of the parent company. Losses of the permanent establishment can only be offset against positive income within the scope of the limited liability to pay taxes in Germany. Both a loss carry-back and a loss carry-forward is possible for the income of a permanent establishment.

If the parent company is a corporation, the profits of the permanent establishment will be subject to corporation tax at the rate of 25% (2003 26.5%). Since 2008 the corporate income tax is payable at a rate of 15% of taxable income.

### **Solidarity surcharge**

A solidarity surcharge on income and corporation tax has been introduced to raise additional funds for the German reunification.

The solidarity surcharge amounts to 5.5% of the respective income or corporation tax burden assessed for the fiscal year.

The surcharge applies to individuals as well as corporations, associations and conglomerations of property with limited or unlimited tax liability in Germany.

The solidarity surcharge has been introduced only as a temporary tax burden. It is to be phased out eventually although no definite time has been set by legislation.

### **VAT**

In principle, value added tax (VAT) is a tax on the consumer collected in stages throughout the business chain and is collected, eventually, by the business supplying the consumer, whether that be an individual or a business which is not registered for VAT. If a business fails to charge or account for VAT correctly, it will have to account for both the VAT and any penalties from its own resources and thereby, by default, VAT becomes a charge on the profits of the business. Put simply, the business person is a tax collector.

The VAT liability can fall under one of three main headings:

- "taxable" at the standard rate of currently 19 % or at the reduced rate of 7 %
- "exempt"
- "outside the scope" of Germany.

### **Church Tax**

Residents in Germany who have chosen officially register themselves as members of the Roman Catholic or Protestant-Lutheran churches are liable to church tax. Church tax is not a subcategory of personal income tax. However, the amount of church tax depends on the personal income tax liability.

Depending on the federal state, church tax amounts between 8% and 9% of an individual's personal income tax burden. Church tax is collected by the tax authorities and distributed among the churches.

Secular persons or members of other religious affiliations are not liable to pay a church tax.

## 7. Accounting & reporting

### Accounting and corporate recordkeeping

Adequate financial records must be kept by all businesses operating in Germany. The books must show clearly all commercial transactions and the financial position pursuant to generally accepted accounting principles. The bookkeeping must be maintained in such a way that an outside expert can derive from it within a reasonable time an overview of the business operations and the position of the firm. The business operations need to be comprehensible from their origins through to completion.

At the end of each financial year, both unincorporated and incorporated firms must prepare their annual financial statements including a balance sheet as well as an income statement.

In addition, corporations must prepare notes to the financial statement and a management report. The latter must make reference to the development of the company's main business activities. Furthermore, an assessment of the present situation and future developments must be made. The notes to the financial statement must include details as prescribed by statute and by law. These details need to give further explanation to individual items in the balance sheet and income statement respectively.

German legislation has incorporated the rules and regulations of the EEC Fourth Directive on accounting and reporting issues, the EEC Seventh Directive on consolidated accounts, and the EEC Eighth Directive on account control and external auditing requirements. The last modification was made with the implementation of the EU-Fair-Value-Directive and the EU-Modernisation-Directive.

The required statutory corporate records generally include:

- The documents of incorporation
- The company articles
- All minutes of shareholders' meetings
- A register of shareholders and directors
- Prescribed accounting documents

The prescribed accounting documents include the following:

- Commercial business records, inventories, opening balance sheets, annual financial statements, management reports, procedural instructions and other organisational documents necessary for interpreting such documents
- Incoming business correspondence
- Copies of mailed business correspondence.

The records need to be kept regularly for ten years. If the documents are needed for tax purposes, a longer period of keeping may become effective.

The German Commercial Code (HGB) also prescribes the preparation of inventories for the close of every business year. The inventory must be taken within a period consistent with orderly business practice. Certain procedures for simplifying the keeping of an inventory are allowed if they are in accordance with generally accepted accounting principles. The informational value of the inventory prepared by these methods must match the informational value of an inventory prepared on the basis of a physical count.

### **Audit requirements**

Unincorporated companies are generally not obliged to appoint an external auditor. The audit and disclosure requirements do, however, take effect when certain size criteria are met. These are currently set at:

- A balance sheet total exceeding EUR 65 million
- An annual turnover exceeding EUR 130 million
- An annual average of more than 5,000 employees.

At least two of the above thresholds must be exceeded on three successive balance sheet dates.

The audit requirements for corporations and for the special limited partnership (GmbH & Co. KG, see above) are contained in the German Commercial Code which groups corporations into three class sizes effective 2009:

	small	medium
Balance sheet total	≤ EUR 4,840,000	≤ EUR 19,250,000
Turnover	≤ EUR 9,680,000	≤ EUR 38,500,000
Employees	≤ 50	≤ 250

Small corporations are those that do not exceed at least two of the aforementioned criteria. Medium-sized corporations are those that exceed at least two of the criteria in column one but, at any given time, do not exceed at least two of the criteria in column two. Corporations that exceed two of the criteria in column two are classified as large. The respective characteristics need to be met on two successive balance sheet dates. Companies listed on the stock exchange are always classified as large corporations.

The annual financial statement and the management report of companies which are not small according to the aforementioned definition must be examined by an external auditor. Only the audited annual financial statements can be adopted.

The legally required consolidated financial statement and consolidated management report of companies always need to be examined by an external auditor.

### Disclosure requirements

The legal representatives of companies must file at the electronic commercial register the annual financial statement without undue delay after its presentation to the shareholders, but no later than nine months (small corporations: 12 months) of the following business year after the closing day. The law distinguishes again between the different class sizes:

	small	medium	large
disclosure of balance sheet	CR	CR	FG
income statement	-	CR	FG
notes to the financial statement	CR	CR	FG
management report	-	CR	FG

CR = Commercial Register  
 FG = Federal Gazette \*)

Large corporations are also subject to disclosure of their annual financial statements and of the management report in the Electronic Federal Gazette.

## 8. UHY firms in Germany

### Berlin

UHY Lauer & Partner

Zimmerstraße 23

D-10969 Berlin

Germany

Phone +49 30 22 65 93-0

Fax +49 30 22 67 90 50

e-mail [berlin@uhy-berlin.de](mailto:berlin@uhy-berlin.de)

website [www.uhy-berlin.de](http://www.uhy-berlin.de)

contact: Reinhold Lauer at [lauer@uhy-berlin.de](mailto:lauer@uhy-berlin.de) or

Dr. Ulla Peters at [peters@uhy-berlin.de](mailto:peters@uhy-berlin.de)

With offices also in:

- Bremen
- Cologne
- Hamburg
- Munich
- Rostock

For current contact details, please visit:

[www.uhy-deutschland.de](http://www.uhy-deutschland.de)

## 9. UHY offices worldwide

For contact details of UHY offices worldwide, or for details on how to contact the UHY executive office, please visit [www.uhy.com](http://www.uhy.com)