German Tax Reforms of 2000 and 2001 —
A Summary for Foreign Investors

On October 23, 2000, the much-discussed and far-reaching Tax Reform was adopted and came into effect on January 1, 2001, including the Supplementary Tax Reduction Act, which passed the upper house of German parliament on December 1, 2000. The new legislation contains some long-expected cuts in personal and corporate income taxes, as well as some new changes, such as the systematic change from tax credit system to a partial exemption system.

On August 15, 2001 the Federal Government voted for a draft bill of the Further Tax Development Act (Unternehmenssteuerverentwicklungsgesetz), which continues the development of tax reduction and contains further modifications on taxation of corporations. The act provides for further tax relief for partnerships and sole proprietorships. It also closes some unintended loopholes of the Tax Reform 2000. In December 2001, the parliamentary process was finalized. Some of the recent changes will become effective retroactive as of January 1, 2001.

I. Highlights of Tax Reforms

A) Highlights of the Tax Reform 2000

• The rate of corporate income tax was reduced from 30 percent – 40 percent down to 25 percent.
• The tax imputation system was abolished. Intercompany dividends between German corporations are exempt from tax. Individual shareholders are only taxed on 50 percent of the dividends received from corporations.
• A national participation exemption was introduced. All capital gains realized directly or indirectly by a German corporation from the sale of shares in a German subsidiary are exempt from tax. (Previously, such exemption was available only in a sale of shares in a non-German subsidiary).
• German thin capitalization rules for foreign investors were tightened.
• The depreciation of assets was restricted.
• The “conversion model”, which enabled a step up in basis upon a conversion of a corporation into a partnership, was abolished.
• The quota for a material holding in a corporation was reduced from 10 percent to 1 percent. Consequently, the gain resulting from the sale of shares in corporations is tax exempt if the seller owns less than 1 percent of the corporation (previously less than 10 percent).

B) Highlights of the Tax Reform 2001

• The requirements for a fiscal unity for trade tax purposes have been adapted to the requirements for a fiscal unity for corporate tax purposes.
• The transfer of assets between partnerships and partners and vice versa is tax neutral under certain conditions.
• Partnerships and sole proprietorships are entitled to a tax free rollover of capital gains up to €500,000 from the disposal of corporations if such capital gains are utilized for the investment in another corporation.
• No tax relief is available for the disposal of only a part of a partnership interest by individuals.
• Portfolio dividends (participation of less than 10 percent) are subject to trade tax. Expenses connected to such dividends are deductible for trade tax purposes.
• Capital gains by corporations from the disposal of partnership interests are subject to trade tax.
• Dividends and capital gains are defined as active income in the context of CFC-regulations.
• Dividends and capital gains are tax exempt if the income of a CFC was subject to tax.

II. Reform of Taxation of Corporations

A. Reduction of Corporate Income Tax Rate

Under the old German system of income taxation of corporations, retained earnings were taxed at a rate of 40 percent, while distributed earnings were taxed at a reduced rate of 30 percent. If retained earnings are distributed in subsequent years, the corporation was entitled to a 10 percent tax credit.

Under the new corporate income tax legislation, profits of corporations are taxed at a rate of 25 percent, regardless of whether those profits are distributed. Based on a comparison of corporate income tax rates (including the 5.5 percent German solidarity surcharge) imposed on retained earnings, Germany has now one of the lowest corporate tax rates of all industrialized countries. Even if the trade tax, which is imposed on German businesses and corporations on a regional basis, is factored into this comparison, German corporate taxes on income are lower than the aggregate taxes imposed upon a corporation operating in New York City.

The same tax rates are applicable on German permanent establishments of foreign corporations and on foreign corporations being a partner in a German partnership.

B. Repeal of Tax Imputation System

Under the new corporate tax law, the imputation system is replaced by the so-called half-income system. Individual shareholders receiving dividends no longer benefit from a tax credit for corporate income taxes paid. Instead, only 50 percent of the dividends received by individual shareholders are considered taxable income for purposes of computing their individual income tax. Intercompany dividends received by German corporations from their German as well as foreign subsidiaries are exempt from corporate income tax. This exemption will apply regardless of the extent of interest held in the German subsidiary.

With respect to existing retained earnings of German corporations, the Tax Reform 2000 contains transitional rules pursuant to which available corporate tax credits may be claimed for a 15-year period commencing on January 1, 2001. For that purpose, the total tax credit available for each German corporation will be calculated as at the end of the last fiscal year ending on or after December 31, 2000. In the following years, the tax credit of the corporation can be utilized when dividends are distributed to its shareholders. The corporation tax is reduced by 1/6 of the dividend distributed.

C. CFC-Act

An additional tax is imposed in Germany on the profits of the passive activities of a subsidiary resident in a tax-haven jurisdiction, in order to ensure the effective taxation of retained foreign dividends to German shareholders. Therefore, the German CFC-Act (Außensteuergesetz) had been amended so that, if the foreign corporation is resident in a jurisdiction imposing less than 25 percent income tax on retained earnings from passive activities, the retained earnings of foreign corporations were taxed as if dividended to German shareholders. The tax rate on such a "fictitious" dividend was 38 percent irrespective of whether the shareholder had a positive tax basis. The participation exemption was not applicable.

The Tax Reform 2001 provides some changes to the CFC-Act.

Dividend income is now defined as active income. The same now applies to capital gains of foreign corporations. Consequently, dividend income and capital gains of CFCs are no longer taxed in Germany.

The Tax Reform 2001 abolishes the separate taxation of the passive CFC-income at a rate of 38 percent. As a result, the passive income can be netted with losses of the individual shareholder and the individual income tax rate will be relevant. The same applies to corporations.

D. Introduction of National Participation Exemption

While capital gains derived from the sale of shares of foreign subsidiaries have generally been exempted from corporate income tax on German corporations since 1984, capital gains derived by German corporations from the sale of shares in German subsidiaries have always constituted taxable income. Such gains are now tax free after December 31, 2001 in most cases.

E. Fiscal Unity (Organschaft)

Under the former legislation, the recognition of a fiscal unity between a parent company and a subsidiary required a
financial, organizational, and economic integration of the subsidiary as well as a profit transfer agreement. If such a fiscal unity was desired by both companies, parent company and subsidiary elected such a unity by concluding the relevant contracts (e.g. profit transfer agreement, Gewinnabführungsvertrag or domination contract, Beherrschungsvertrag).

Under the new law, apart from the requirement of a profit transfer agreement, only the financial integration of the subsidiary is necessary to achieve fiscal unity for corporate income tax purposes. Financial integration exists when the parent company is directly or indirectly majority shareholder of the subsidiary from the beginning of the fiscal year of the subsidiary. Thus, majority participation and a profit transfer agreement will result in fiscal unity for corporate income tax purposes. These changes simplify structuring and reduce substance problems within German holding structures.

The Tax Reform 2001 adapts the requirements for a fiscal unity for trade tax to the requirements for a fiscal unity for corporate income tax. This further simplifies implementation of holding structures.

Additionally, the Tax Reform 2001 simplifies the requirements for a cross-border fiscal unity for corporate income tax purposes as long as the foreign entity is subject to German tax law.

F. Trade Tax

In order to prevent an improper use, the Tax Reform 2001 abolishes the exemption of trade tax on capital gains of a corporation from the disposal of partnership interests. As a result, trade tax exemption will be maintained only on capital gains from the sale of partnership owned by individuals.

Formerly, lease payments for assets of a German lessee except real property were deductible at 50 percent only, if the lessor was not subject to trade tax. This legislation did not conform with European law because it discriminated against foreign lessors.

The Tax Reform 2001 increases the amount of deductible lease payments to 75 percent and applies also if the lessor is subject to trade tax. Therefore, there is no longer a difference in taxation between a domestic and a foreign lessor.

The Tax Reform 2001 introduced retroactively as of the tax year 2001 the taxation of portfolio dividends (shareholding less than 10 percent). As a consequence all business expenses connected to such dividends are deductible (long-term interest only at 50 percent).

G. Real Estate Transfer Tax for Intra-Group Transfer of Real Estate

The Tax Reform 2001 was initially supposed to simplify and support the restructuring within a group of affiliated companies by exempting the transfer of real property within a group of affiliated companies from real estate transfer tax. However, this proposal was rejected.

III. Reform of Personal Income Taxation

A. Reduction of Income Tax Rates

The main reform of personal income taxes relates to the reduction of individual tax rates in the years 2002 through 2005. These changes will have only indirect effects on businesses. The changes are briefly summarized as follows:

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<th>Year</th>
<th>Reductions in Personal Income Tax</th>
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| 2001 | Credit for trade tax paid by individuals operating through a partnership or a sole proprietorship.  
Tax-free allowance of individuals increases to Euro 7,235 (DM 14,150); reduction of entrance level of progressive tax rate to 19.9 percent; reduction of marginal tax rate to 48.5 percent. |
| 2003 | Tax-free allowance of individuals increases to Euro 7,426 (DM 14,523); reduction at entrance level of progressive tax rate to 17 percent; reduction of marginal tax rate to 47 percent. |
| 2005 | Tax-free allowance of individuals increases to Euro 7,664 (DM 14,989); reduction of entrance level of progressive tax rate to 15 percent; reduction of marginal tax rate to 42 percent and downward adjustment of all intermediate tax rates. |

B. Taxation of Capital Gains

In the past, German individual shareholders could realize capital gains derived from the sale of non-material shareholdings in corporations free from income tax, unless the capital gain was realized during a six-month speculation period. Effective January 1, 1999, the threshold for non-material holdings was reduced from 25 percent to 10 percent; in addition, the holding period was extended to 12 months. Moreover, existing opportunities for a tax-exempt stock-swap were substantially limited.

The Tax Reform 2000 further diminished the possibilities of a tax-free capital gain by reducing the threshold of non-material holdings to 1 percent effective January 1, 2002. Consequently, only minor shareholdings mainly in publicly listed companies may be disposed of tax-free. In contrast to these revenue raising measures, the income tax on capital gains realized from the sale of material shareholdings or during the 12-month holding period will be imposed only on 50 percent of the gain.
IV. Reforms 2001 Concerning Partnerships and Sole Proprietorships

A. Transfer of Assets Between Partners and Partnerships and Vice Versa

Before the Tax Reform 2000 it was possible to transfer assets tax free between partnerships and partners and vice versa. These opportunities were restricted under the Tax Reform 2000. The Tax Reform 2001 contains some clarifications in respect of such asset transfers but also reverses most of the restrictions introduced by the Tax Reform 2000.

Now a tax neutral transfer of assets between partnerships and partners and vice versa is again possible. However, to the extent corporations are partners and undisclosed reserves are transferred to them, such transaction is not tax neutral. To prevent tax avoidance, a holding period of seven years applies in respect to such assets. The transfer of assets will be taxed retroactively if the assets are sold in this period. In certain cases a different holding period of three years applies. This specific period starts in the year in which the relevant tax return is filed with the tax authorities.

B. Taxation of Capital Gains and Reserves

Under former legislation, the partnerships and sole proprietorships are claimants for a specific tax-free reserve. The Tax Reform 2001 provides that in the future, the partner or the sole proprietor is the claimant. Consequently, the partner of a partnership will be able to claim this reserve and to roll over certain capital gains of the partnership to other assets even if these assets belong to another partnership.

The Tax Reform 2001 provides an additional tax benefit by permitting the rollover of capital gains from corporations to an equity investment in another corporation or to land and buildings up to an amount of €500,000. Therefore a tax-free reserve can be created.

Formerly, the disposal of a part of a partnership interest was tax privileged, while the capital gain from the sale of a part of an individual business was taxed. Because of the comparability of these activities, a different taxation of both cases is not justified. In the future, a disposal of a part of a partnership interest will be taxed as ordinary business income.

C. Trade Tax Exemptions

The Tax Reform 2000 already had introduced a reduction of the tax burden of partnerships and sole proprietorships by crediting the trade tax against the income tax liability of the individual. The trade tax is still deductible as operating expenditure at the level of the partnership or enterprise. The consequence for the majority of partnerships owned by individuals is that they will have a full relief from trade tax.

V. Summary and Conclusion

The German Tax Reform Act has clearly increased Germany’s competitiveness and attractiveness for inward investment by reducing its historically high nominal tax rates to levels more in line with those of its big trading partners. The further Tax Development Act supports this development and gives further incentives for investors to medium-sized businesses. It also closes some loopholes and removes some unintended results of the Tax Reform Act.

Further Information

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