Germany's Reform of Company Taxation 2008

Reducing the Tax Burden for Companies

On January 1, 2008 Germany's reform of company taxation came into effect. By combining flexibility and simplicity with moderate tax rates, Germany has developed one of the most competitive tax systems in Europe. The reform of company taxation has made Germany even more attractive as a location for international business.

The reform aims at reducing the tax burden for all companies. One core element is a nearly one-quarter reduction of the average tax burden for corporations. On average, corporations now face an overall tax burden of less than 30 percent.

Partnerships will benefit from a reduction of the personal income tax on undistributed profits, which is aimed at creating 'tax neutrality' between the different legal company forms.

All businesses will benefit from a reduction of the trade tax burden – this reduction has been achieved by both reducing the trade tax assessment rate and increasing the weighting factor.

The subsequent pages offer a closer look at Germany's tax system improvements.

The Main Improvements at a Glance

For corporations
Reduction of the corporate income tax burden

For partnerships
Reduction of the income tax burden
on retained earnings

For all businesses
Reduction of the trade tax burden

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Corporations – Reducing the Corporate Income Tax

The average tax burden for corporations – composed of corporate income tax, trade tax, and the solidarity surcharge – will be reduced by roughly 9 percentage points, from 38.7 to 29.8 percent.

The total reduction is achieved primarily by reducing the corporate income tax by 10 percentage points (from 25 to 15 percent). The levy of a solidarity surcharge on the corporate income tax remains unchanged.

Interest payments remain fully deductible as operating expenditure up to the amount of interest earnings. However, an **'interest stripping rule'** ('*Zinsschranke*') has been designed to prevent interest payments from reducing taxable gains below a certain level. Accordingly, interest payments in excess of interest earnings are deductible only up to the amount of 30 percent of the EBITDA (earnings before interest, taxes, depreciation, and amortization).

However, this limitation does not apply:

- to a fully deductible allowance of up to EUR 1 million in interest payments (in excess of interest earnings of the same fiscal year), or
- if the business operation does not or only partially belong to a corporate group, or
- if the business operation belongs to a corporate group and the equity ratio ('*Eigenkapitalquote*' – the ratio of equity capital to balance sheet total) of the business operation in its IFRS balance sheet is equal to or higher than that of the corporate group (the 'escape clause'). Falling short of the corporate group equity ratio by up to 1 percentage point is not harmful.

For corporations, the latter two exemptions apply only if interest paid to certain qualified loan creditors does not make up more than 10 percent of interest payments exceeding interest earnings. Non-deductible interest payments are carried forward to future assessment periods.

Average Tax Burden for Corporations after the Reform - Exemplary Calculation

	Corporate Tax Burden in 2008
Taxable Corporate Income	EUR 1,000,000
- Trade Tax *	– EUR 140,000
- Corporate Income Tax (15 %)	– EUR 150,000
- Solidarity Surcharge (5.5% on the Corporate Income Tax)	– EUR 8,250
Net Income	EUR 701,750
Overall Tax Burden	~ 29.83 %

* Assuming an average municipal collection rate of 400%.

Partnerships - Reducing the Personal Income Tax

In order to achieve 'tax neutrality' between the different legal forms under which a company can be registered in Germany, the rate of personal income tax applicable to retained earnings ('thesaurierte Gewinne') of a partnership will also be reduced to 29.8 percent – 28.25 percent plus solidarity surcharge. This facilitates the creation of private equity capital. This 'retention option' is particularly interesting for large partnerships, as the rate of personal income tax will only rise above 30 percent if substantial profits are generated. More than 80 percent of companies subject to personal income tax are currently subject to a rate of less than 20 percent. Only after distribution to the shareholders would the earnings be liable to an additional 25 percent of subsequent taxation, provided that the annual balance between capital contributions and withdrawals exceeds the annual profits. The overall tax burden on distributed earnings would therefore add up to approximately 47.5 percent, roughly correspondent to the tax burden on distributed dividends of corporations.

Changes for all Business Operations - Reducing the Trade Tax

1. Reducing the Tax Assessment Rate

- The trade tax assessment rate ('*Steuermesszahl*') has been reduced from 5 percent to a uniform 3.5 percent.
- The resulting trade tax base value ('*Steuermessbetrag*') continues to be multiplied with the municipal collection rate ('*Hebesatz*') in order to determine the individual local trade tax burden.

2. Increasing the Weighting Factor

Trade tax payments can be offset against personal income tax with a weighting factor ('*Anrechnungsfaktor*') of 3.8 – more than twice the current factor of 1.8. Trade tax payments are deductible only up to the amount of trade tax actually paid.

3. Addition of Interest Payments

The mandatory addition of 50 percent of all interest payments on long-term debts to the trade tax assessment basis has been abolished. Instead, 25 percent of all interest payments and financial commitments will be added. Payments on rent, lease, or licences will only be considered at a fractional amount in this context. The new system will facilitate trade tax assessment by rendering the hitherto requisite differentiation between short-term and long-term liabilities obsolete.

Changes Regarding Depreciation and Distribution of Profits

Abolition of the Declining Balance Depreciation

Declining balance depreciation has been abolished for all goods purchased after 2007. All depreciations must apply the straight-line method from 2008.

Modification of the Immediate Write-Off Regulations

The full value of individually usable, depreciable movable assets up to EUR 150 net (instead of the previous EUR 410 net) have to be written off as an operating expense in the first business year. Goods with net production or acquisition costs between EUR 150 and EUR 1,000 must be pooled annually and written off equably over five years.

Modification of the Allowances for Future Investment (*'Ansparabschreibung'*)

In order to create tax relief for small and medium-sized enterprises, tax allowances for future investments have become more generous. Companies with capital equipment valued at EUR 235,000 or less are permitted to offset up to 40 percent of anticipated future costs for acquisition or production of depreciable movable assets against currently generated profits. To do so, the company must plan to acquire or produce the privileged assets within the 3 fiscal years following the allowance and to use it in a domestic business branch at least until the end of the fiscal year following acquisition or production. The aforementioned allowances can be claimed even where these result in a loss. The previous EUR 154,000 limit for allowances has been increased to EUR 200,000. Moreover, allowances are now admissible for second-hand investment goods.

Capital Gains Compensation Tax (*'Abgeltungssteuer'*)

Beginning in 2009, a uniform flat-rate 25 percent compensation tax (plus solidarity surcharge) will be levied on all capital gains and proceeds from the sale of private capital assets, with the exception of real estate. Thus the total tax burden on capital gains will be reduced from a maximum of 52.2 percent to 48.3 percent. Tax payers subject to a personal income tax rate under 25 percent have the option of individual assessment in their tax declaration in order to avoid paying unnecessarily high fees. The compensation tax is directly transferred to the tax authorities through the bank or domestic debtor.

- Limitation of the Bank Account Query

After the introduction of the compensation tax in 2009, the bank account query used to verify capital gains will no longer be required, except in a few specific cases set out in the General Fiscal Code (*'Abgabenordnung'*).

- Abolition of the *'Speculative Period'*

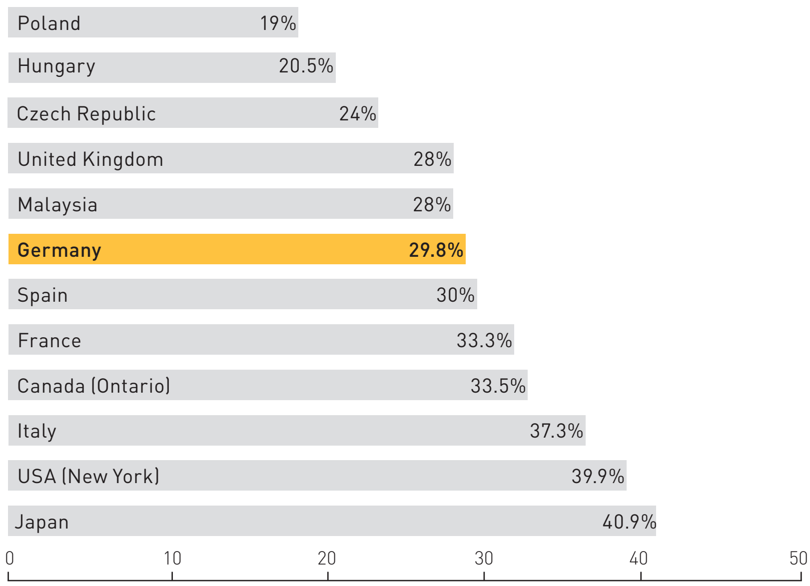
Along with the introduction of the capital gains compensation tax, the 'speculative period' (or sale period) will be abolished. So far, gains from the sale of private securities have been tax-exempt when resold after a minimum holding period of 12 months. From 2009 onward, gains from the sale of private securities or investment funds will also be subject to the 25 percent compensation tax, irrespective of the holding period. The new system applies to all capital assets purchased after December 31, 2008.

- Abolition of the *'Half-Income System'*

The current 'half-income system' with respect to private capital gains will cease to exist after 2009. From that point on, 100 percent of all dividends and speculation gains, rather than the current 50 percent, will be taxed. However, with the new capital gains compensation tax and the corporate income tax cuts, the overall tax burden on dividends will still be lowered. The tax rate will no longer be the shareholder's personal income tax rate, but the flat 25 percent compensation tax. Shareholders with an individual personal income tax rate of less than 25 percent can request that their individual tax rate be applied.

The newly created capital gains compensation tax will become effective as of January 1, 2009; all other changes outlined above will become effective as of January 1, 2008

Corporate Tax Burden 2008 - An International Comparison



Sources: Federal Ministry of Finance, bfai, German Chambers of Commerce Abroad