

1. Introduction

- 1.1. Generally, taxes are administered and enforced by the competent local tax office. These local tax offices administer in particular the income tax to be paid by individuals, Corporate Income Tax (CIT) to be paid by corporations as well as Value Added Tax (VAT) and Real Estate Transfer Tax (RETT), where applicable. Trade tax is based on the assessment of corporate taxes but is enforced and assessed by the local municipalities
- 1.2. The Federal Central Tax Office (*Bundeszentralamt für Steuern*) is, among other things, responsible for foreign taxpayers, e.g. for the exemption and tax refund of withholding tax according to double tax treaties and EU directives, advanced transfer pricing agreements as well as the issuance of tax rulings for foreign investors and for several measures in connection with VAT on cross-border supplies and services.

2. Companies

- 2.1. **Corporations**, such as the German Limited Liability Company (*GmbH*) or Stock Corporation (*AG*) that are tax-resident in Germany are subject to CIT on their worldwide income, unless relieved by double tax treaties. Corporations are resident in Germany if their effective place of management or their registered office (*Sitz*) is located in Germany. The place of management is the centre of the top management of a corporation. It is located where the commercial matters of some importance for the corporation are effectively decided, usually at the directors' office. The registered office of a corporation is determined by the articles of association of the corporation. Foreign corporations that have neither its place of management nor its registered office in Germany are only subject to CIT on their German-source income.
- 2.2. **The calculation of the taxable income** is based on the annual financial statements (*Handelsbilanz*) drawn up pursuant to German generally accepted accounting principles which must then be modified under specific provisions of tax law. These notably include regulations on the treatment of hidden profit distributions and restrictions on the deductibility of business expenses, in particular with respect to debt financing expenditures.

- 2.3. The taxable income includes the corporation's current profits or losses as well as any capital gains. In general, the entire profit is fully taxable. However, there are some exemptions. For example, the German Corporate Tax Act provides for a 95% tax exemption of dividends received, as well as capital gains from the sale of shares in other German or foreign corporations, unless certain restrictions apply. However, this tax exemption may not be available if the selling corporation is a bank or other financial institution or, under certain conditions, is a holding company that holds the shares as trading assets. Further, to qualify for the exemption relating to dividends, the parent company must hold at least 10% of shares in the subsidiary. The tax exemption applies irrespective of a minimum holding period. In return, any losses arising from the ownership of shares, as for example from the disposal or liquidation, are not tax deductible on the level of the corporation.
- 2.4. The CIT rate is 15%. In addition, the solidarity surcharge of 5.5% is levied on the amount of CIT due, resulting in an **aggregate tax rate of 15.825%**. The local tax office where the central management of the corporation is located is the competent office for assessing the CIT.
- 2.5. Corporations are also subject to **municipal trade tax**. Foreign businesses which do not have their registered office or place of management in Germany but receive income which is allocated to a German permanent establishment are also subject to trade tax. The basic trade tax rate is 3.5% which is supplemented by the application of a multiplier fixed by the competent municipality and that varies from a minimum rate of 200% up to around 500%. Thus, the effective trade tax rate ranges from 7% to around 17.5%. As a result, corporations are subject to CIT (including solidarity surcharge) and trade tax at a **combined rate between 22.825% and 33.325%**. For trade tax purposes, the above mentioned 95% tax exemption of dividends received from other corporations requires a minimum shareholding of 15% as of the beginning of the respective fiscal year.
- 2.6. Both CIT and trade tax are assessed on an annual basis. However, the determination of the taxable income may refer to a 12-month period deviating from the calendar year. Additionally, corporations are obligated to make quarterly prepayments of CIT and trade tax which are based on an estimate of the current year's tax amount due.

2.7. For CIT and trade tax purposes, a general limitation to the deduction of interest payments applies, relating to both third party loans and shareholder loans. Under the interest deduction ceiling (*Zinsschranke*), interest expenses exceeding interest income (net interest) will only be deductible up to 30% of the corporation's EBITDA (earnings before interest, taxes, depreciation and amortization). The interest deduction ceiling will apply (a) if the overall net interest exceeds €3 million (threshold) and (b) in case that the corporation does not belong to a group of companies, if a "harmful debt financing" is in place, which is a debt financing by shareholders with more than 25% shareholding, related parties or third parties (e.g. banks) with recourse to such shareholders or related party, and interest paid for such debt exceeds 10% of the overall net interest; or (c) in case that the corporation belongs to a group of companies, if "harmful debt financing" exists in any group company and the financing 25% shareholder, related party or third party with recourse to the shareholder or related party is not part of the group; or the equity ratio of the borrowing corporation is lower than the one of the consolidated group. Net interest expenses that are not deductible under these rules may be carried forward to subsequent financial years and may only be deducted within the limits of the interest deduction ceiling.

2.8. **Transfer pricing:** Under the arm's length principle, the consideration of any intercompany transaction must conform to the level that would have applied if the transaction would have taken place between unrelated third parties. In cases where the arm's lengths principle is not met, the tax authority may be entitled to adjust the tax base resulting in an additional taxable income. The tax office may also charge penalties. Further, tax payers are required to maintain proper transfer pricing documentation in cases of intercompany cross-border transactions with respect to the type and content of the business relationships with related parties including details on the calculation of transfer prices. In case that no or insufficient documentation is available, the tax authorities are entitled to estimate a higher tax base and, additionally, penalty payments may be assessed.

2.9. The German rules for **groups of companies** (*Organschaft*) under the Corporate Income Tax Act require a more than 50% shareholding in a subsidiary and a profit and loss transfer agreement (*Ergebnisabführungsvertrag*) according to German corporate law, which is concluded between the group parent company and the subsidiary and executed for a period of at least five years. As a result, the subsidiary's net income is attributed to the group parent company for CIT and trade tax purposes.

2.10. **Dividends:** In general, corporations have to withhold taxes for all dividends and other profit distributions, irrespective of whether the recipient or shareholder is a German or foreign entity. The withholding tax is 25% plus the additional solidarity surcharge of 5.5%, resulting in an aggregate tax rate of 26.375%. The withholding tax is creditable at shareholder level against the overall CIT liability. In case that a foreign corporation is subject to limited tax liability in Germany, the withholding tax can be reduced to 15.825% (including solidarity surcharge) if certain substance criteria are met. An exemption from withholding tax applies under the EU Parent-Subsidiary Directive for distributions to foreign EU corporations with a minimum shareholding of 10%. The withholding tax can also be reduced to a lower rate or be avoided/reclaimed under a respective double tax treaty. However, the reduction as well as limitation and exemptions under the EU Parent-Subsidiary Directive or the double tax treaties are subject to a German anti-treaty shopping rule whereby the limitation or exemption is not available if the recipient is an interposed entity with insufficient "substance".

2.11. **German partnerships**, as for example the General Partnership (*OHG*) or Limited Partnership (*KG*), are not subject to income tax or CIT. Instead, CIT or income tax is levied at the level of the partners of the partnership (transparency principle). The income is determined "uniformly and separately" on the level of the partnership and attributed to the partners in proportion to its equity interest in the partnership. The income tax rate for partners is equivalent to the tax rate for individuals. Partnerships may obtain business income or conduct private asset management. Partnerships which only conduct private asset management, as for example generating dividends, interest or lease income, do not gain business income. The partnership itself is subject to municipal trade tax in case its activities can be qualified as a trade under the German Trade Tax Act. However, the trade tax can generally be offset to a large extent with the personal income tax liability of an individual partner in proportion to its equity interest in the partnership.

3. Individuals

3.1. **Tax liability:** A person's taxation status in Germany depends on its residence status. An individual is deemed to be a resident in Germany if the individual has a domestic domicile or a domestic customary place of abode. Nationality is not a relevant criterion for determining the residence status or tax liability of individuals under German tax law. A resident individual is subject to unlimited tax liability that means it is taxed on its worldwide income. If an individual is not resident in Germany but generates income from a German source, it will be generally taxed on its German-source income (limited tax liability).

An individual's tax liability includes the income tax, solidarity surcharge and trade tax levied on business income.

3.2. Taxable income: Resident individuals will be taxed on its worldwide income to the extent that the income can be assigned to one or more of the seven categories of income enumerated in the German Income Tax Act (ITA). Such taxable income includes, for example, income from business including capital gains on sale of shares in a corporation held by the individual as private assets with a minimum shareholding of 1% within the previous five years, rental income, income from employment and self-employment, as well as investment income (e.g. dividends, interests).

The income from employment includes the value of all benefits provided to the employee, e.g. salary payments, bonuses, benefits in kind (private use of a company car, granting stock options) and other forms of remuneration (for example insurance payments). If the employer grants stock options to the employee at a reduced price or for free, the taxable event generally is only the transfer of the shares to the employee. The difference between the fair market value of the shares at the time of the transfer and the price paid by the employee to acquire the stock option will be taxed.

Non-resident individuals are only taxed on certain types of income received from a German source enumerated in the German ITA. The following taxable events are included:

- Income from business related to a domestic permanent establishment or a permanent agent in Germany;
- Capital gains on the sale of shares in a corporation if the non-resident individual holds a minimum of 1% of the corporation's capital in the previous five years;
- Income from the lease or sale of domestic real estate;
- Income from employment and self-employment to the extent that the personal service is performed or used in Germany;
- Certain income from investment of capital (e.g. dividends if the debtor of the dividends has a domestic residence or business seat).

3.3. Tax rates: The general tax rates and personal exemptions in 2015 are the following:

Annual Earnings	Marginal Tax Rate
Up to €8,354 (basic allowance)	0%
€8,355 – €52,881	14% – 42% (sliding scale)
€52,882 – €250,730	42%
more than €250,730	45%

The above stated amounts are doubled if married couples file joint tax returns.

In addition to income tax, a solidarity surcharge of 5.5% is levied on the assessed income tax. If the individual is a member of an "approved" church, the church is entitled to levy a church tax on the income tax. The tax rate is either 8% or 9%, depending on the federal state of the individual's residence.

The income from capital investment, e.g. dividends, interests (private capital assets), is generally not taxed at the standard tax rates but at a flat rate withholding tax of 25% plus solidarity surcharge of 5.5% (altogether 26.375%) and church tax, if applicable. The tax liability of the individual is generally discharged if the respective tax is withheld by the domestic paying bank or custodian. If a capital investment is held as a business asset, the income derived from such investment is not subject to the flat rate withholding tax, but to standard taxation. Therefore, only 60% of the respective business income (partial-income rule) will be taxed with the personal tax rate of the taxpayer. However, also only 60% of business expenses are deductible.

Under certain conditions the taxpayer is entitled to opt for a standard taxation instead of the flat rate withholding taxation. This applies, for example, with respect to the income from dividends if the taxpayer holds at least 25% of the shares in the distributing corporation or holds at least 1% of the shares and is also employed by the corporation.

3.4. Deductions: The taxable net income from employment, lease and certain other income (e.g. private capital gains in relation to the sale of real estate with a holding period less than ten years) will be generally calculated on the basis of the received income deducted by any income-related expenses (*Werbungskosten*). However, there are some lump sum annual deductions for such income-related expenses if the taxpayer does not file higher expenses. In 2015, the taxpayer is, for example, entitled to deduct:

- for employment income: €1,000
- for annuities: €102

In case that the investment income is charged at the flat rate withholding tax of 25%, the taxpayer can reduce its taxable investment income by a saver's standard deduction in the amount of €801 (€1,602 for married taxpayers filing jointly). The taxpayer is not entitled to deduct any further expenses related to the investment income.

In addition, taxpayers can also deduct certain special expenses (e.g. for social insurance, and for donations to non-profit organisations) or certain expenses for extraordinary burdens.

3.5. Trade tax: The business income of individuals is also subject to trade tax. However, trade tax can generally be offset to a large extent against the personal income tax liability of the respective taxpayer.

3.6. Social security contributions: These contributions are designed to secure social security benefits, such as unemployment benefit and sickness benefit. They are effectively an additional charge to income tax and are payable by both the employee and employer on the earnings of an employee working in Germany. Certain contribution assessment ceilings restrict the gross income from employment relevant for the deductible social security contributions. The most relevant social security contributions for 2015 are summarised in the following tables:

Contribution Assessment Ceiling	Annual Amount (€)
Pension and unemployment insurance	72,600/62,400 (for the new Eastern States of Germany)
Health and nursing care insurance	49,500

	Contribution Rate Employee	Contribution Rate Employer
Pension insurance	9.35%	9.35%
Unemployment insurance	1.5%	1.5%
Health insurance	7.3% (general) 7.0% (reduced)	7.3% (general) 7.0% (reduced)
Nursing care insurance	1.175%	1.175%

4. Other Taxes

4.1. Value Added Tax (VAT): VAT is a sales tax which is charged on taxable supplies of goods and services made by a taxable person in the course of any business activity carried on in Germany and on the importation of goods from other states. The German VAT Act is harmonized under the EC-wide VAT system.

The standard VAT rate for supplies of goods or services in Germany currently amounts to 19%. A reduced rate of 7% exists for certain basic goods and services like food, books, animals, theatre tickets and hotel accommodation. There are further supplies of goods and services that are generally exempted from VAT such as intra-EC supplies of goods, sales of shares and certain financial services. For some of such VAT-exempted supplies, for example, the sale and letting of real estate, the entrepreneur is entitled to opt for a taxation of these supplies.

Tax charged on supplies made is called output tax. A supplier may in turn have incurred VAT on goods and services received (input tax). Such input tax can be offset against output tax provided that the supplier makes taxable supplies. If and to the extent that the input supply is used to render VAT-exempt output supplies, the respective input tax is generally not deductible. However, if input tax is related to certain VAT-exempt cross-border supplies, the entrepreneur can still claim for a deduction of this input tax.

VAT must be filed to the local tax authorities, typically on a quarterly basis. Where input tax paid can be set off against output tax received, only the balance has to be paid. If input tax exceeds output tax, a refund may be obtained. Special rules apply if a taxable person makes both taxable and non-taxable supplies, which have the effect of restricting the input tax relief to the taxable element of supplies received (see above).

4.2. Stamp duty and real estate transfer tax (RETT): No stamp duty is charged on the transfer of shares under German tax law.

The transfer of real estate located in Germany is generally subject to RETT (asset deal). RETT will be triggered by the conclusion of a purchase agreement or, for example, a transaction that gives the right to another party to claim for a transfer of the real estate.

The RETT rate depends on the federal state where the real estate is located and ranges between 3.5% up to 6.5% of the purchase price or, if there is no consideration, of the real estate's value calculated under the provisions of the German Valuation Act.

Apart from an asset deal, RETT is also triggered in case of a direct or indirect transfer of at least 95% of the interest in a partnership, which owns real estate within a period of five years to new partners (share deal). Such transfer is deemed as a taxable transfer of the partnership's German real estate to another partnership.

The real estate is taken into account to the extent that it is owned by the partnership during the whole term in which at least 95% of the interests in the partnership have been transferred. Any direct and indirect transfer of partnership interest has to be accumulated, whereby a change of the shareholders of a partner (corporation such as a GmbH) will be only considered if 95% or more of the shares in the corporation are transferred to a new shareholder.

RETT is also triggered if at least 95% of shares in a company which owns real estate are directly and/or indirectly held in the hand of one acquirer, of controlling and depending companies or of depending companies only. Shares in affiliated companies that hold at least 95% of shares in the real estate holding company can only be attributed to the acquirer for RETT purposes if the acquirer also holds at least 95% of shares in the affiliated company or if the special requirements of a RETT group are fulfilled.

RETT is additionally triggered if a person acquires, directly or indirectly, at least 95% of the "economic interest" in a company, which owns real estate. The amount of the "economic interest" will be calculated by multiplying the direct or indirect participations in the capital and/or assets of the entities involved.

Certain intra-group reorganizations under the German Reorganization Act, which would generally trigger RETT, are tax-exempt if the respective reorganization meets very restrictive exemption requirements (e.g. holding of at least 95% of the relevant companies for a period of five years each prior to and following the reorganization).

RETT is assessed by the local tax authority for the area in which the real estate is located.

Contact Information

Dr. Christian Bleschke

Rechtsanwalt, Steuerberater
Fachanwalt für Steuerrecht
Partner
T +49 30 72 616 8220
E christian.bleschke@squirepb.com

Michael Langer

Rechtsanwalt, Steuerberater
T +49 30 72 616 8220
E michael.langer@squirepb.com

Squire Patton Boggs Berlin

Unter den Linden 14
10117 Berlin
Germany

Squire Patton Boggs Frankfurt

Taunusanlage 17
60325 Frankfurt am Main
Germany

The contents of this update are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations nor should they be considered a substitute for taking legal advice.

© Squire Patton Boggs.