

Tax reforms – bad news for business

Dr. Astrid Krüger and Florian Lechner of Oppenhoff & Rädler Linklaters & Alliance assess the tax reform measures proposed by Germany's centre-left Government.

With the federal parliamentary elections on 27 September 1998, Germans voted for a new government consisting of German Social Democrats (SPD) and Alliance '90/The Green Party (*Bündnis '90/Die Grünen*).

Both parties had already announced major reforms of German tax law during the election campaign, particularly in reducing the tax bill of average income families and closing 'loopholes' in German taxation, which are mainly used by companies and taxpayers with high income.

The draft bill on tax reform has been available since 9 November 1998. This draft bill ('Tax Relief Act 1999/2000/2002' *Steuerentlastungsgesetz 1999/2000/2002*), provides for the amendment of the most important German tax codes and ordinances in three stages (see below).

Its focus is on personal income and corporate income tax. However, trade tax, value added tax (*Mehrwert Steuer/MwSt*), gift and real estate transfer tax as well as the reorganisation tax law, are also affected. Although the bill is only a draft, introduced by the members of the coalition parties, it is expected to pass mainly unchanged because the government has a majority both in the German *Bundestag* and the *Bundesrat*.

Unless otherwise mentioned below, all changes shall become effective as of 1 January 1999 or the assessment period of 1999. In the near future, an 'ecological tax reform' will also support the political goals of the new government in the form of an increase of the taxation of energy costs.

The suggested amendments are intended to lead to an improvement in economic growth and employment by increasing companies' investment incentives. The tax burden on employees and families will be perceptibly

reduced and, thus, spending power increased.

Furthermore, the German tax system is intended to become fairer and simpler. The total tax reductions by the three-stage tax reform will amount, according to the calculations of the coalition parties, to approximately DEM57bn. The relief will be financed by taxpayers in the amount of approximately DEM42bn as calculated by the coalition.

However, some economists have recently suggested that the amount raised by counterfinancing measures will be higher. The draft bill includes a list of 78 counterfinancing measures which mainly affect companies and investors. The most important changes are summarised below.

Tax rates

The tax rates for personal income tax and corporate income tax will be reduced in three steps. However, the draft bill does not provide for amendments with respect to the 5.5% solidarity surcharge on personal and corporate income tax, which had been introduced to cover the financing of the extra costs associated with the reunification of Germany.



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1st Step (from 1 January 1999)

Corporate income tax:

- reduction of the tax rate for retained profits from 45% to 40%; and
- maintenance of the tax rate for distributed profits at 30%.

Personal income tax:

- reduction of the minimum tax rate from 25.9% to 23.9% and of the privileged income tax rate for gains from business income from 47% to 45%; and
- maintenance of the top rate for income other than business income at 53%.

2nd Step (from 1 January 2000)

Personal income tax:

- reduction of the minimum tax rate from 23.9% to 22.9%;
- reduction of the top rate from 53% to 51%; and
- reduction of the privileged income tax rate for gains from business income from 45% to 43%.

3rd Step (from 1 January 2002)

Personal income tax:

- reduction of the minimum tax rate from 22.9% to 19.9% and of the top rate from 51% to 48.5%.



Florian Lechner

FIGURE 1 Present and future top rates

	Personal income tax		Corporate income tax		
	Ordinary income	Business income	Corporations resident in Germany		PEs of foreign corporations
			Retained profits	Distributed profits	
1998	53%	47%	45%	30%	42%
1999	53%	45%	40%	30%	40%
2000	51%	43%	40%	30%	40%
2002	48.5%	business tax at a general rate of 35%			

The special corporate income tax rate for domestic permanent establishments of corporations, which is at present 3% lower than the rate for retained profits, will be abolished with the first step.

Therefore, profits of non-resident corporations will be subject to the rate for retained profits in future. In our view, this constitutes a further intensification of the discrimination of foreign EC corporations which we consider to be incompatible with EC law (see *Blumenberg, Tax Notes International, 1997 p. 1025; Rädler and Lausterer, Der Betrieb, 1994 p. 699*).

With the third step of the reform, ie from 2002 onwards, all income of enterprises – those taxable under the corporate income tax law and those taxable under the personal income tax law – shall be subject to a business tax at a general rate of about 35%.

The new government has announced a plan to call a special commission with both federal and state representatives and with the participation of scholars and trade associations which shall prepare the fundamental reform of company taxation until the year 2000.

Figure 1 gives an overview on the present and future top rates.

Accounting for tax purposes

Write-downs

According to the Tax Relief Act, write-downs to a lower going-concern value of assets, which are presently possible, shall, for tax purposes, be prohibited in the future.

This change is to take effect for fiscal years ending after 31 December 1998. The amendment will not only broaden the basis for taxation but also lead to a diversion of accounting for tax purposes from statutory accounting. To realise a decrease in the value of an asset for tax

purposes, in future the asset will have to be sold or contributed.

Recapture

Additionally, any write-down made in the past to a lower going-concern value must be recaptured for tax purposes in 1999. Up to

now, such a recapture was not necessary, with the result that an upward revision in value could not be taxed. Now the compulsory re-increase in value will lead to taxable income.

However, profits from such a taxable write-up can, to a limited extent, be apportioned over five years by building up a reserve in the first year and release in future years.

Accrued liabilities

Reserves that, at present, have to be set aside for future liabilities in cash or cash equivalents at their full amount, will, according to the Tax Relief Act, in the future, have to be discounted to their present value.

Restrictions concerning the valuation of other liabilities for which reserves are set aside and concerning the setting up of reserves in the field of nuclear power plants are also to be imposed.

Capital gains

Threshold for substantial interests

Currently, the sale of interest in a corporation is principally tax free if the interest (held in the private assets) has not amounted to more than 25 % of the corporation within the last five years. This threshold will be lowered to up to 10%. This means that the sale of an interest in a corporation that has amounted to at least 10% within the last five years will be taxed. The last five years also include the last five years before the Tax Relief Act.

Transfer of hidden reserves

Several non-legislative rules which provide for a tax free transfer of hidden reserves:

- in the case of certain exchanges of shares (under the so-called

'Tauschgutachten');

- between entrepreneurial partners and the partnerships (so called 'Mitunternehmererlaß'); and
- by means of the establishment of an entrepreneurial split-up between the operational business and land and buildings, shall be abolished.

Additionally, the tax-neutral transfer of hidden reserves in land and buildings which is currently possible under several sections of the Personal Income Tax Act will no longer be possible according to the Tax Relief Act.

Capital gains on private assets

At present, capital gains resulting from the sale of real estate and other assets, such as securities, can only be taxed if they are realised within a holding period of two years (for real property) or six months (for other assets).

These periods will be extended by the Tax Relief Act to 10 years and one year respectively. There will not be a holding period for real estate used as a personal dwelling.

Furthermore, margin-transactions which are based on the difference between the stock exchange or market price and a fixed basic value on selected fixed dates (eg commodity forward transactions, forward transactions in securities or currency forward trading) are included for the first time in the taxation of speculative gains.

Sales of assets which have been withdrawn from business capital, will, in future, have to be held for 10 years (real estate) or five years (other assets), in order not to be taxed under the speculative gains provision.

Capital gains on business assets

The German Personal Income Tax Act privileges so-called extraordinary income resulting from sales of certain business assets such as complete or partial businesses, entrepreneurial participations in partnerships and substantial interests in corporations by taxing it at a rate only half of the regular tax rate. This privilege will cease to exist. Instead, taxation will be calculated by a rather complicated method, that is only beneficial for small incomes.

Losses

Loss carry-back

The loss carry-back currently permitted under German tax law will be abolished

SNAPSHOT OF KEY CHANGES

Personal income/corporate income tax

- Three-stage reduction between 1 January 1999 and 1 January 2002.

Accounting

- Depreciation – writedowns to a lower going-concern value of assets prohibited from 31 December 1998.
- Recapture – any past writedowns to a lower going-concern value of assets must be recaptured in 1999.
- Accrued liabilities – Reserves set aside for future liabilities in cash or cash equivalents will only be discounted to their present value.

Capital gains

- Threshold for substantial interests lowered to up to 10%.
- Several rules allowing a tax-free transfer of hidden reserves will be abolished.
- Tax-neutral transfer of hidden reserves in land and buildings will be abolished.
- The period for realising gains from the sale of real estate and other assets such as securities will be extended to 10 years and one year respectively.
- Additional margin transactions on speculative gains will be included.
- Sales of assets withdrawn from business capital will have to be held for 10 years to avoid being taxed.
- Extraordinary income from sales of certain business assets, entrepreneurial partnerships and substantial interests in corporations will be taxed in such a way as to benefit small incomes only.

Losses

- Loss carry back to be abolished by 2001.
- Losses not set off in the accrued can only be carried forward to future years.
- Setting off of losses will be limited between different kinds of income.

Foreign activities

- Business expenses arising from participation in a foreign corporation will no longer be deductible.
- There will be restrictions on use of foreign losses.
- Tax deductions for bribes given to foreign judges and officials will be abolished.

as of the assessment period of 2001. For the years 1999 and 2000, a loss carry-back will remain possible up to the amount of DEM2m (presently DEM10m) for one preceding year only (presently two years).

Loss carry-forward

As of 2001, losses which are not set off in the year accrued can only be carried forward to future years. Other than speculated before the publishing of the Tax Relief Act Draft, there shall be no limit to such loss carry-forward.

Off-setting of losses

Additionally, the off-setting of losses shall be limited between different kinds of income. Losses related to income from activities classified as passive activities (such as income from capital assets, leasing and letting, etc.) shall only be offset against income from other passive activities.

A set-off against income from active activities shall be limited to an amount of DEM100,000 (in case of singles) or DEM200,000 (in case of joint assessment of spouses). Above that amount, a consolidation is only permitted up to 50 % of the amount of active income not set-off so far.

Foreign activities

The planned amendments will also affect the business activities of German companies in foreign countries.

Deduction of refinancing of foreign subsidiaries

Business expenses, eg debt interest, which arise in connection with a participation in a foreign corporation, the dividend distributions of which are tax-exempt pursuant to a double taxation treaty or the EC Parent-Subsidiary Directive, may no longer be deducted.

At present, the deductibility of such expenses is only prohibited to the extent to which tax-exempt dividends are actually distributed. Consequently, the so-called 'ballooning concept', ie the retaining of profits at the level of the foreign subsidiary in order to maintain the deductibility of expenses related to the subsidiary, will in future be hindered by law.

Loss utilisation

Other 'tax broadening measures' consist of restrictions with respect to the utilisation of foreign losses. Losses which

result from the sale of an intercorporate participation (ie participation of at least 10%, which remain domestically tax-free according to a double taxation treaty), shall no longer be deductible.

A similar discarding of a beneficial rule shall apply to foreign losses of permanent establishments located in a double taxation treaty country. However, the recapture provision for losses deducted in the past shall remain effective.

**Other refinancing measures
Bribes**

Finally, tax deductions for bribes given to foreign officials and judges shall be prohibited in future. At present, the deductions of bribes is only excluded in case the payer or the recipient is caught and convicted of bribery – which happens rather rarely. However, the new measure shall not apply to bribes which are paid to individuals and not to officials.

Deductibility of interest on fiscal claims

Furthermore, the deductibility of interest on additional fiscal claims, and in cases of respite or suspension will be disallowed. Therefore, regarding an application for a suspension, it has to be considered whether a bank credit would be more favorable than the suspension interest (which is at 6% pa).

Conclusion

As companies and investors are severely impaired by most of the amendments described above, the Tax Relief Act is unlikely to be a relief for both. These two groups automatically become the net payers of the 'red/green' tax reform.

Therefore, it seems most unlikely that the reform will be an appropriate measure to reduce unemployment and strengthen Germany's economy.

Furthermore, the Tax Relief Act does not meet its aim of simplifying the German tax system. Accordingly, it has been widely criticised in Germany. However, there does not seem to be a large chance for major changes to be made to the draft. ■

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