GERMANY PROVIDES SOUND BUSINESS OPPORTUNITIES FOR INTERNATIONAL CORPORATIONS. **FRIEDRICH PHILIPPS** AND **ANDREAS NESTELE** EXAMINE THE KEY ISSUES FACING CORPORATE TREASURERS, INCLUDING THE REGULATORY ENVIRONMENT, THE MAIN CASH MANAGEMENT PRACTICES AND TAXATION ISSUES.

EXPORTS BOLSTER GERMAN

After a three-year stretch, Germany's economy is growing again, albeit not as fast as in some other Economic Monetary Union (EMU) countries. German companies are standing up well against global competition, as strong export growth and a rising share in global exports demonstrate. An important element in corporate restructuring was the creation of cross-border value chains. German companies have capitalised on the opportunities presented by European Union (EU) enlargement. As a result, Germany is now one of Central and Eastern Europe's major trade partners. In intra-EMU trade, Germany has benefitted from a relatively moderate increase in unit labour costs in recent years. The common currency has improved the price competitiveness of goods and services from Germany. Due to the absence of currency fluctuations, transaction costs of trade in the euro zone have decreased and earnings from trade have become more calculable.

Germany's economic policy is also believed to be heading in the right direction. The measures of '*The Agenda 2010*', which was introduced mainly to curb social spending will put an end to the trend of higher contributions being offered to finance social security schemes. This is important as payroll taxes are the main reason behind Germany's high labour costs. Steps have also been taken to make the labour market more flexible. Another task is to secure Germany's innovation capabilities. Output is still strong, especially in products with advanced technology, but the basis of knowledge is eroding, now that there is a relatively low share of the population with higher and university education. However, necessary reforms of the education system are underway to combat this problem.

THE CASH MANAGEMENT LANDSCAPE – THE REGULATORY ENVIRONMENT. In Germany, a clear distinction is made between resident and non-resident entities. This may have some bearing when deciding the legal status of an overseas company conducting business in the country. A company is considered a resident if either its legal registration – corporation or branch – or its place of effective management is Germany.

Residents are permitted to open and maintain accounts in euros and foreign currencies, domestically and abroad. The opening of foreign currency accounts abroad by residents must be reported. Non-residents are permitted to hold foreign currency accounts and to maintain bank accounts in Germany, denominated in either domestic or foreign currency. Since the abolition of the 2% interest-free reserve requirement in 1998, banks can pay interest on corporate deposits in line with rates available in other euro zone countries. There are no restrictions on the payment of interest for credit balances on current accounts and short-term deposits.

According to Central Bank reporting regulations, all payments in excess of €12,500 between residents and non-residents, and payments made or received on residents' accounts abroad, have to be reported to the Deutsche Bundesbank, Germany's central bank. Many banks will deliver information on outgoing payment transactions to the Bundesbank on their clients' behalf. Naturally, the accuracy of all reported information is the corporate's responsibility. With effect from January 2006, a new EU regulation will require central bank reporting for payments above €50,000.

PAYMENTS AND CLEARING SYSTEMS. Cashless payments are widespread in Germany and most transactions are processed automatically. The most prominent payment instrument in terms of volume and value in Germany is the credit transfer. It is used for salaries, pensions, tax and social security payments as well as treasury payments.

Direct debits are also common for regular payments and are increasing in volume. Two types of direct debits exist: non-pre-authorised and pre-authorised. The pre-authorised direct debit is used for payments between companies and generally involves higher value amounts.

Credit card payments are widely accepted in Germany but are not heavily used for cashless payments. Cheques are still an accepted instrument in business transactions.

RECOVERY

The German banking system

For foreign companies, the German banking system might appear rather complicated. Indeed, it has historically been, and still is, very fragmented with a total of some 2,200 savings banks (mostly Sparkassen and Landesbanken), credit co-operatives (Volksbanken and Raiffeisenbanken) and private banks co-existing. Although the number of banks has halved since 1990 and some market concentration has occurred in the German banking sector in recent years, in line with the development of the euro zone, it is still low in comparison to other European countries. In Germany, the five largest banks have a market share of only 20% (the so called G5 concentration rate, based on total assets), which is just half of the European average (39%). This is due, in part, to 36% of the German market being dominated by savings banks and Landesbanken which, under law, cannot be taken over. However, as of July 2005, there will be a phasing out of state guarantees for the public banks which will lead to a more market-oriented behaviour and, hence, a less distorted playing-field. Coupled with increased competition across the euro zone, the result is likely to be a stronger wave of consolidation in the German banking sector.

A unique feature of German banking is the long tradition and dominant position of universal banks. Most German banks still offer a full range of domestic and international banking services. Another distinct characteristic of the German system is that bank credit has long been established as the basic funding instrument for many companies. This is a legacy of both benign factors (banks being able to make loans suiting a customer's maturity preferences due to a low-inflation environment) as well as less benign ones (non-risk adequate pricing, privileged treatment of loans in relation to equity instruments). Over the past few years and in anticipation of the new Basel Accord taking shape, innovative alternatives in corporate financing have grown in demand.

Table 1 Market share of cashless payments (retail)

Credit transfer	53.4%
Direct debits	38.1%
Electronic cash	4.4%
Credit cards	3.0%
Cheques	1.2%

Source: EURO Kartensysteme EUROCARD und eurocheque GmbH, Postbank, Bank for International Settlement, Basel (May 2002)

Germany offers two distinct clearing systems: RTGS^{plus}, the Real-time Gross Settlement system, and RPS, the Retail Payment System (also known as *Elektronischer Massenzahlungsverkehr* or *EMZ*) – Germany's automated clearing house. Individual, urgent payments with same-day value are cleared through RTGS^{plus}, while RPS is designed for bulk payments or non-urgent transactions. RTGS^{plus} is currently the largest payment system in the euro zone, with a market share of almost 50%. In addition to RTGS^{plus} and RPS, there is a strong inter bank-clearing system in Germany, handling more than 95% of domestic bank-to-bank payments based on agreements between the banks.

ELECTRONIC BANKING. Electronic banking solutions, both on a domestic and international scale are widespread in Germany. MultiCash, a liquidity control and cash management system developed by Omikron, has effectively become a nationwide bank-independent standard, allowing corporates to access all their German bank accounts via one and the same electronic banking system. Most German banks offer MultiCash either alongside or instead of their proprietary systems. With the recent changes in European VAT restrictions, there is a surge of interest in the electronic bill presentment and payment solution (db-eBills) in Germany and across Europe.

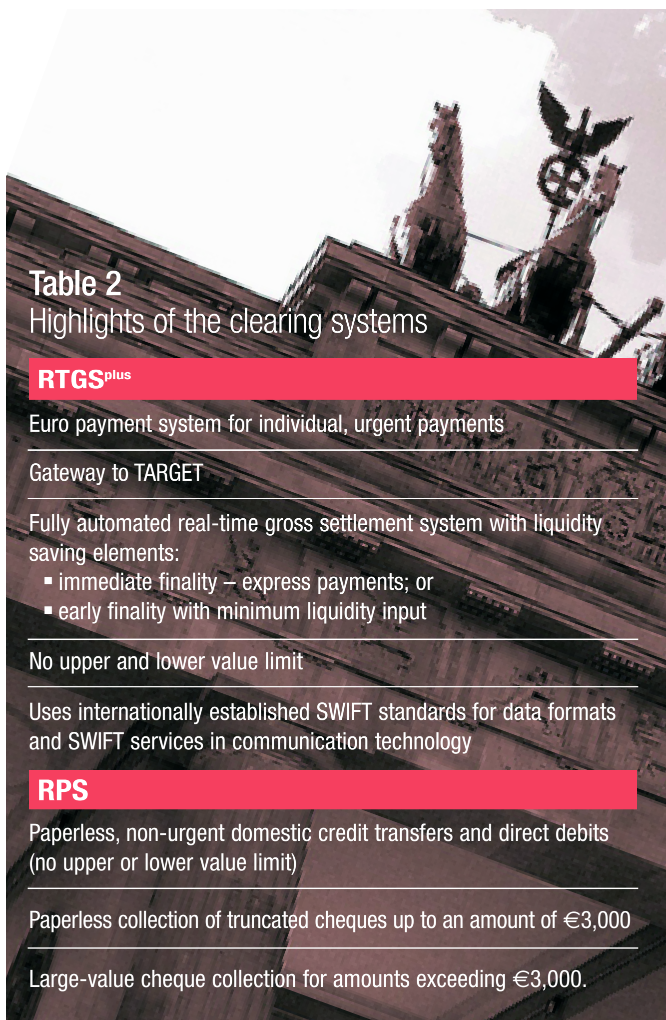

Table 2
Highlights of the clearing systems

RTGS^plus
Euro payment system for individual, urgent payments
Gateway to TARGET
Fully automated real-time gross settlement system with liquidity saving elements: ▪ immediate finality – express payments; or ▪ early finality with minimum liquidity input
No upper and lower value limit
Uses internationally established SWIFT standards for data formats and SWIFT services in communication technology
RPS
Paperless, non-urgent domestic credit transfers and direct debits (no upper or lower value limit)
Paperless collection of truncated cheques up to an amount of €3,000
Large-value cheque collection for amounts exceeding €3,000.

LIQUIDITY MANAGEMENT. Treasurers considering liquidity management structures in Germany should be aware that notional pooling is permissible in Germany but that it is subject to a strict regulatory framework for offsetting debit and credit balances. This does, however, make multi-entity notional pooling structures rather unattractive. Within the current set of rules, balance sheets can be offset if there is:

- a single currency;
- a single legal entity on the bank side (all accounts located in one jurisdiction); and
- a single legal entity on the corporate side, although multiple accounts may exist.

Zero balancing is, however, the preferred and most prominent liquidity management technique employed in Germany.

Larger German banks offer monthly 'inter-company settlement reports' via e-mail and fax as an alternative for those corporates who do not wish to calculate inter-company liquidity positions themselves on a daily basis using dedicated software solutions. Alternatively, corporates can download the relevant data and execute the calculations using electronic-banking software packages. This enables them to calculate inter-company interest in-house, based upon the relevant sweeping transactions, uploaded via an electronic banking tool.

TAXATION ISSUES. In Germany, the taxes that must be taken into account by corporate treasurers are corporate income tax, withholding tax, capital gains tax and thin capitalisation. Once again, residency status plays a key role, especially when considering the EC Parent–Subsidiary Directive and double taxation agreements with non-European countries.

CORPORATE INCOME TAX (CIT). Resident companies are subject to taxation on their worldwide income. All income is categorised as business income and is subject to CIT, currently 25%, and CIT-deductible business/trade tax, which varies by municipality between 13% and 21%. CIT is subject to a non-deductible 5.5% solidarity surcharge that has been levied since the reunification of Germany in 1991. In contrast, the profits of non-resident companies are subject to a 20% CIT rate plus business/trade tax and solidarity surcharge.

WITHHOLDING TAX. A withholding tax of 20% is levied on dividends paid by German companies to residents and non-residents (plus a 5.5% solidarity surcharge). EU-based non-residents can avoid withholding tax on dividends under the EC Parent–Subsidiary Directive. Non-residents, whose parent company is located in France, Luxembourg, the Netherlands or the UK, may qualify for a reduced rate of 10%.

Interest paid to resident individuals is subject to a withholding tax of 30% (plus a 5.5% solidarity surcharge). Interest paid to non-residents is generally exempt from withholding tax. Tax treaties cap the maximum rate of withholding tax on payments to non-residents domiciled in particular countries.

CAPITAL GAINS TAX. Income derived from the sale of shares in foreign and German corporations is tax-exempt, regardless of the size of the shareholding or any minimum holding period, although certain exemptions exist. Capital losses incurred in connection with the sale of shares, the reduction of nominal capital or a special write-off are not deductible. Capital gains derived from the sale of other assets are generally taxed at ordinary CIT rates, while capital losses are generally deductible.

THIN CAPITALISATION. Last but not least, tax restrictions apply to foreign shareholders who directly or indirectly hold more than 25% of the share capital of a German corporation. Interest payments made by a German subsidiary to a qualifying foreign shareholder will qualify as non-deductible constructive dividends if the underlying loan granted by the foreign shareholder (or related party) exceeds certain debt-to-equity ratios. If a corporation can prove it would have received the loan on the same terms and conditions from an unrelated third party, then an exception may be granted. Interest on inter-company loans from a foreign parent company is only tax deductible when the debt-to-equity ratio does not exceed 1.5:1 for an operating company and 3:1 for a holding company where the foreign parent establishes a German holding with at least two active subsidiaries.

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