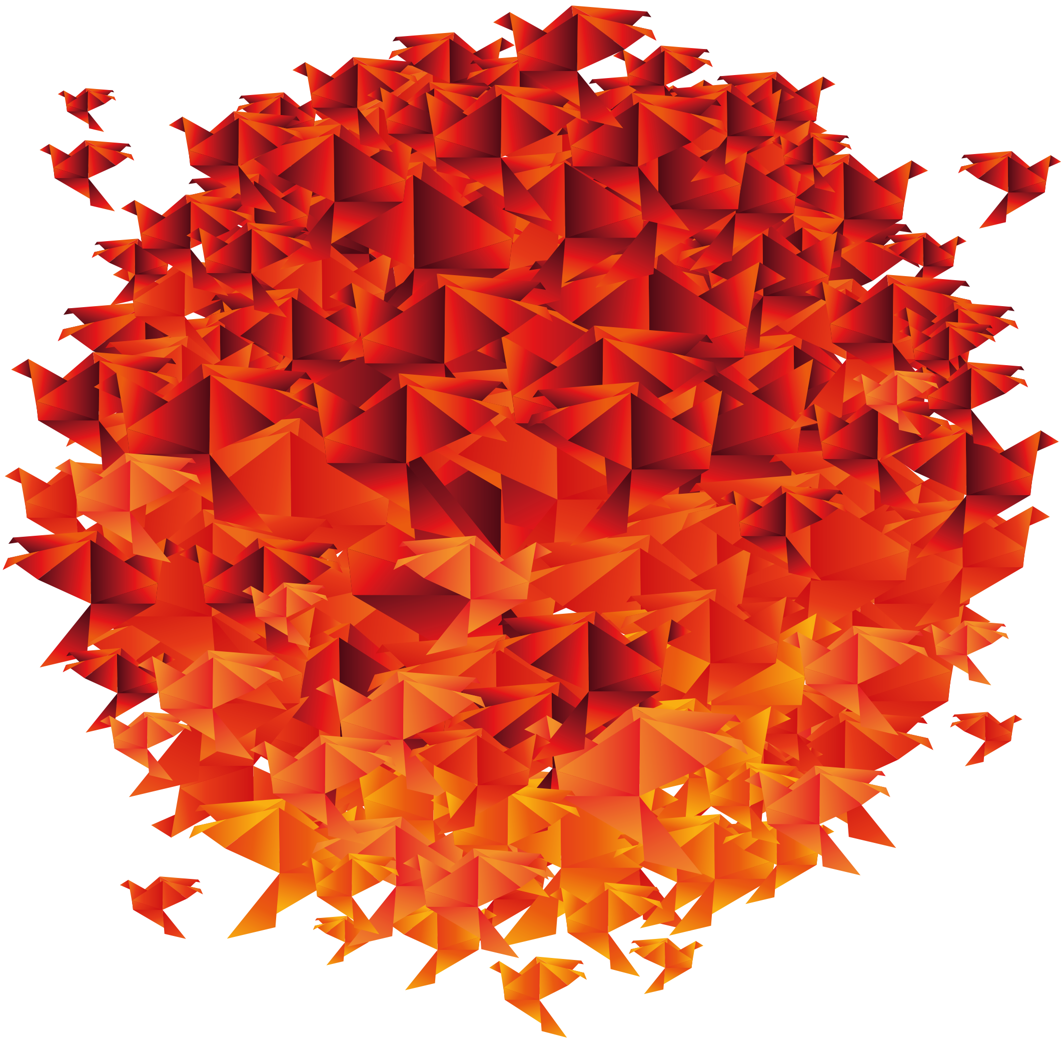

Introduction to income taxation of German corporations and partnerships

Highlighting the general principles of income taxation of German corporations and commercial partnerships

Background

German income taxation of German corporations and German commercial partnerships is subject to deviating taxation concepts that are recommendable to be upfront considered when contemplating to pursue business operations in Germany.

The following summarizes key aspects around the different taxation concepts.

German income taxation of corporations – General aspects

Tax rates

Corporations with legal seat and/or place of management in Germany are subject to corporate income tax (CIT) of 15 percent plus 5.5 percent Solidarity Surcharge (SolS) thereon, combined 15.825 percent, based on German domestic tax law.

Corporations are generally also subject to trade tax (TT) with regard to income generated in German branch/operations.

The TT rate depends on the levy rate set forth by the municipality where the operations of the respective company are located. There are quite significant differences in the municipal levy rates across the various municipalities within Germany. Some municipalities levy TT at rates below 10 percent while in general the TT rate ranges between 14 percent and 17 percent, but may also be higher.

Taxable income

If a corporation has its legal seat and/or its place of management in Germany, the corporation is subject to unlimited taxation in Germany, i.e., all its worldwide income is subject to CIT and TT in Germany.

If a corporation has neither its legal seat nor its place of management in Germany but is generating German source income (e.g., dividend, royalty income, German permanent establishment, shares in a German based corporation, etc.), its German source income should be subject to German taxation with CIT and in case of a German permanent establishment also with TT.

In each case, implications of double tax treaties resp. of EU directives would need to be considered as well and Germany's taxation rights may be limited or fully shifted away from Germany.

A corporation's German taxable income is determined on the basis of the local statutory accounts, plus adjustments for tax purposes (e.g. non-deductible expenses, tax-exempt dividend income, adjustments due to different valuation of/accounting for assets and liabilities in German statutory vs. tax balance sheet, etc.).

The adjustments that have to be made for CIT purposes are basically applicable for TT purposes as well. However, additional adjustments must be made for TT purposes, e.g. a 25 percent add-back of interest expenses or certain deemed interest components included in rental expenses, royalties, etc. (after deduction of an allowance of EUR 100k).

German income taxation of commercial partnerships – General aspects

The most common commercial partnership structure in Germany includes a German GmbH & Co. KG: A German KG should always need at least two partners – one being the limited partner, one being the general partner. Typically the general partner holds a minimum or a 0 percent stake in the KG.

Transparency principle

In contrast to corporations, commercial partnerships operating in Germany are treated as being transparent for German income tax purposes. This means that the taxable income of a German partnership is allocated to its partners and taxed at their level with personal income tax (if the partner is an individual) or with CIT (if the partner is a corporation). Also in case the partner is a non-German individual or corporation, the income allocated from the commercial partnership operating in Germany should generally be subject to German income taxation.

A partnership carrying out commercial business operations in Germany is in contrast however subject to TT on its own (i.e., insofar the partnership is not transparent).

The taxable income for TT purposes is based on the taxable income as derived for income tax purposes in a first step. This means that adjustments that have to be made for income tax purposes are basically valid for TT purposes as well. In a second step, there are additional adjustments to be performed for TT purposes, like e.g. the 25 percent add-back of interest expenses and comparable expenses (generally, the same principles for trade tax add-backs should apply like those for corporations – see above).

Since a commercial partnership is subject to TT on its own, such TT income (or loss) of the partnership is deducted (or added back in case of a loss) from the TT basis of the partner in order to not consider that TT income (or loss) twice for TT purposes.

Special rules for determination of taxable income

Special rules apply for the determination of the taxable income of a commercial partnership. These special rules in particular include the income from supplementary tax balance sheets as well as from special tax balance sheets.

The income of a partnership for tax purposes typically consists of the following components:

01. Income of the commercial partnership itself based on the statutory profit/loss and considering balance-sheet adjustments from the partnership's statutory balance sheet to the tax balance sheet,
02. Income resulting from so-called supplementary balance sheets ("Ergänzungsbilanzen") – see below,
03. Income relating to assets and liabilities of the partners, which relate to the business of the partnership ("Sonderbetriebseinnahmen/-ausgaben", "Sonderbetriebsvermögen I und II") deriving from special purpose balance sheets ("Sonderbilanzen") – see below, as well as
04. off-balance sheet adjustments such as tax non-deductible expenses or tax-free income.

Supplementary balance sheets
The acquisition of a commercial partnership interest is considered to be an acquisition of the partnership's assets and liabilities for income tax purposes, so that the acquisition costs of a partner for its participation in the partnership are booked in the partner's supplementary tax balance sheet to the extent that the acquisition costs exceed or fall short of the proportionate net tax equity of the partnership.

The acquisition costs are, thereby, allocated to the different assets (incl. goodwill) owned by the partnership and depreciated/amortized (to the extent allocable to depreciable/amortizable assets) in the following years.

Special purposes balance sheets
Special purpose balance sheets are set up for each partner of a commercial partnership and include those assets and liabilities of the partner which relate to the partnership such as e.g. loans granted by a partner to the partnership, real estate or other assets leased to the partnership, as well as loans taken on by the partner to debt-finance the acquisition in the partnership interest.

Any income or expenses allocable to the special business assets or liabilities are considered for purposes of determining the taxable income of the partnership. Furthermore, certain considerations for services provided by a partner to its partnership are treated as special business income as well. As a result, e.g. rental payments for real estate, interests or fees paid by the partnership to its partners qualifying as special business income are effectively not deductible at the level of the partnership for TT purposes (since the expenses and income are neutralized with each other).

Utilization of tax losses – General rules
German income tax or TT losses incurred by a corporation or commercial partnership can generally be carried forward indefinitely and be utilized in future years to offset taxable income of the respective entity.

The annual utilization of tax loss carry forwards is amount-wise limited to offset taxable income of up to EUR 1m and thereafter only by 60 percent of the remaining taxable profits (so-called minimum taxation rule) incurred by the entity in the respective financial year.

In addition, for income tax purposes, tax losses of up to EUR 1m (for FY20 and FY21: up to EUR 5m) can be carried back to the immediately preceeding financial year. No carry back is possible for TT purposes.

These rules apply likewise for corporations and commercial partnerships.

Commercial partnerships resp. their limited partner(s) may account for a special category of tax losses pursuant to Sec. 15a German Income Tax Act. These tax losses are essentially arising if and to the extent the limited partner of a commercial partnership is allocated tax losses from the partnership that result in his participation/capital accounts becoming negative or increasing in the negative amount. These are very tax technical matters that should be analyzed on a case-by-case basis in terms of their implications.

The utilization of tax losses in future FYs is subject to the German change-in-ownership rules applicable to corporations as well as to commercial partnerships to the extent corporations are partners and the shares in these corporations are transferred. For details on German change-in-ownership rules please kindly refer to our separate Spotlight brochure on such topic.

Furthermore, as regards commercial partnerships and their tax losses for TT purposes following additional limitations on utilization in future financial years apply:

- Identical partner criterion: If and to the extent a partner in the commercial partnership disposes its stake in the partnership, the TT losses of the partnership should generally insofar be forfeited and not be utilizable after that partner's exit from the commercial partnership.
- Identical business criterion: If the business of the partnership changes, the TT losses of the partnership should be forfeited. The question whether the business has changed needs to be addressed on a case-by-case basis taking into account e.g. its operations, its customer and supplier base, its employees, its management, its branches and its assets.

Repatriation of profits to the investors

The tax treatment of the repatriation of profits from a German corporation resp. a German commercial partnership to its shareholders/partners is essentially reflecting the aforementioned taxation principles as well.

Repatriation of profits from a German corporation

A shareholder can repatriate profits from its German corporate subsidiary by resolving dividend distributions (legal prerequisites to be considered). A dividend paid by a German corporation to its shareholder should be tax non-deductible at the level of the German corporation and should give rise to German dividend withholding of generally 26.375 percent to be withheld from the dividend amount and remitted by the German corporation to the German tax authorities. Such dividend withholding tax rate may be lowered under a double tax treaty between Germany and the country of tax residency of the shareholder or the EU Parent Subsidiary Directive.

In addition, no dividend withholding tax should arise in case the dividend can be paid from the German corporation's tax equity account and such utilization is evidenced in due time.

The tax equity account ("steuerliches Einlagekonto") of a corporation (not applicable to partnerships) represents contributions by the shareholders in the past that have not increased the corporation's share capital. The utilization of the tax equity account is essentially a repayment of contributions to the shareholder and is only possible in case the company does not have any distributable profits and if its utilization is timely and duly evidenced.

Taxation at the level of the shareholder depends inter alia on the tax law of the country in which the dividend receiving shareholder is tax resident.

For example, if the shareholder is (also) a German corporation, dividend income should be 95 percent tax exempt with the remaining 5 percent being subject to CIT and TT (tax rate thus essentially roughly 1.5% on the dividend income – provided that certain conditions are met like minimum shareholding ratio and timing requirements as regards holding the shares where care needs to be taken since otherwise the dividend may be fully subject to CIT/TT and not only by 5%).

If sourced from the tax equity account, the dividend should generally be considered as repayment of shareholder contributions and should not trigger taxable income at the level of the German corporate shareholder but rather be reflected as a decrease of the tax book value of the investment in the subsidiary.

Repatriation of profits from a German commercial partnership

Reflecting the transparency principle applicable to the income taxation of German commercial partnership, the repatriation of profits from a German commercial partnership is a withdrawal by the partner from its capital account.

The historic profits (and losses) incurred by the German commercial partnership are allocated and booked each FY to the capital accounts of the partners. A withdrawal from a partner's capital account should be tax non-deductible at the level of the partnership and should not trigger German withholding tax. At the level of the partner, generally no additional taxation of such profits withdrawn should apply (as such profits should have been already taxed in the year in which they were generated).

Exit taxation

One item to also consider when contemplating whether to pursue an investment in Germany by way of a corporation or partnership could be how the exit from such investment at a later point in time may taxed (noting though that tax rules may change in the future):

Exit from a German corporation

If the party selling the shares in a German corporation is also a German corporation, an arising capital gain should generally be 95 percent income tax exempt (i.e., effective income tax rate of approx. 1.5%) whereas an arising capital loss should generally be income tax non-deductible for the selling German corporation.

Individuals and foreign, non-German tax resident corporations may be subject to different tax implications to be addressed on a case-by-case basis. For example, if the seller is a non-German corporation and the shares in the to-be sold German corporation are not allocable to a German branch of the seller, the taxation of an arising capital gain in Germany may either be excluded under a double tax treaty (if applicable) between Germany and the country in which the seller is tax resident or in case the double tax treaty does not exclude Germany's taxation or no double tax treaty applies, the capital gain should effectively not trigger a German CIT or TT burden pursuant to Federal Tax Court jurisdiction and as applied by the German tax authorities. In this latter case, the non-German seller should though face a tax return filing obligation even if no CIT/TT burden becomes due.

Tax losses of the to-be sold/acquired corporation may be subject to restrictions under German change-in-ownership rules and may not survive the acquisition and may thus not be available to offset taxable income post-acquisition. Details on these rules can be found in the separate Spotlight brochure on such topic.

A share transfer should generally be VAT exempt but could be elected be treated like a VATable transaction under certain preconditions to be reflected case-by-case.

If the target corporation owns German real estate (or similar rights), German real estate transfer tax may arise; purchaser and seller should face notification obligations towards the German tax authorities and timely observing these is important. Details can be found in our separate Spotlight brochure on this topic. Discussions on revising German real estate transfer tax law are ongoing and developments should be closely monitored.

Exit from a German commercial partnership
The taxation of an exit from the investment in a German commercial partnership is reflecting the principle of transparency of the partnership:

A sale of a partnership interest is treated like an asset deal from a German income tax perspective, i.e., it results in a fully taxable disclosure of built-in gains, if any, inherent in the partnership's assets/liabilities that should be subject to TT at the level of the partnership itself and not at the level of the sellers (resp. a loss should generally be fully tax deductible). If the seller of the partnership interest is an individual and is selling its entire partnership interest (incl. all material special business assets/liabilities), an arising capital gain should generally though be exempt from TT.

In contrast, corporate/personal income tax on a gain should generally be payable by the sellers/their partners.

In return, the disclosed built-in gains should be reflected as a step-up in tax basis in the partnership's assets/liabilities and thus increase depreciation/amortization going forward (present value of such benefit should strongly depend e.g. on the partnership's expected future taxable income and the remaining depreciation/amortization period). In case of a loss arising upon the transfer of the partnership stake, the tax treatment of disclosed built-in loss should be addressed on a case-by-case basis.

In order to calculate the step-up (or step-down) as well as the new depreciation/amortization bases of the assets for tax purposes, a purchase price allocation to the assets and liabilities of the partnership should be necessary.

This distinction between taxation of an exit relating to a partnership stake for income tax vs. TT purposes, reflecting the transparency principle, may then give rise to the necessity resp. recommendation to properly consider and account for these implications in the underlying legal agreements for selling the partnership stakes.

TT losses of the to-be sold/acquired partnership should be forfeited to the extent that the partner in the partnership is changed (loss of so-called „Mitunternehmeridentität" or identical partner criterion – see above) and there should be no exemption rules to safeguard the TT losses from being forfeited.

The transfer of a partnership stake should generally be VAT exempt but could be elected be treated like a VATable transaction under certain preconditions to be reflected case-by-case.

If the partnership owns German real estate (incl. similar rights) and at least 95 percent of partnership stakes are transferred within 5 years to new partners (threshold/time frame are in discussion to be changed – tax law developments should be monitored), German real estate transfer tax should generally arise. The debtor of real estate transfer tax may be the partnership itself based on German tax law and the parties involved in the transaction, i.e. purchaser, seller and the partnership, should face notification obligations towards the German tax authorities that would need to be duly and timely observed. Details can be found in our separate Spotlight brochure on this topic. Discussions on revising German real esate transfer tax law are ongoing and developments should be closely monitored.

Additional Remarks

The decision whether to pursue operations in Germany via a corporation or a partnership type entity are depending on various aspects and should be taken from a holistic perspective considering tax as well as non-tax aspects. In terms of potential tax matters to be considered the ongoing taxation rules are summarized herein may be relevant to consider; however, also thoughts around a potential later exit from the investment and the taxation of the exit may need to be factored into the decision making process.

Contacts

Do you have any more questions?
We are looking forward to your call or email to discuss opportunities and requirements in more detail tailored to your needs and your expectations!

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