The Cornerstones of German Tax Reform 2008

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Last week a working group established by the German grand coalition agreed on "cornerstones" for tax reform in Germany in 2008 and 2009. In essence, the plan is to reduce tax rates significantly but to limit the revenue loss through a broadening of the tax base. The reports on the intended changes are still vague. In addition, the "cornerstones" will likely be modified in the law-making process. First draft legislation is not expected before the spring of 2007. These are the key elements:

- The average income tax burden on corporations will be reduced from 39% to just below 30%. To this end, corporate income tax will be reduced from 25% to 15% (in both cases, plus a 5.5% solidarity surcharge thereon). The base rate for municipal trade tax will be reduced from 5% to 3.5%. As is presently the case, the final trade tax rate will depend on the multipliers established by the local municipalities. Municipal trade tax, however, will no longer be deductible as a business expense.

- The tax cuts will also extend to the *Mittelstand*. Germany's largely family-owned mid-size businesses are usually organized as business partnerships, which are transparent for personal or corporate income tax purposes, but not for municipal trade tax purposes. Individuals who own an interest in such partnerships are currently subject to personal income tax at progressive rates of up to 42% (plus solidarity surcharge thereon) on their share of partnership profits. Individual partners can largely credit their allocable share of trade tax paid by the partnership against their personal income tax.

    - In the future, individual partners will pay less personal income tax on undistributed partnership profits so that the aggregate income tax burden (including trade tax, which will remain creditable) on such profits will not exceed 30% (*i.e.*, the average income tax burden on corporations). Upon distribution, the tax advantage against higher progressive tax rates will be recaptured and the final flat tax for dividends (*see* below) will apply.

- Introduction of an "interest barrier" (*Zinsschranke*): Net interest expense will no longer be deductible currently (but can only be carried forward) if it exceeds a certain percentage of EBIT. The details are still unclear. The working group seems to have agreed on the following framework:

- Interest (apparently, this will include interest on third-party loans) will no longer be currently deductible (but must be carried forward) if net interest expense (*i.e.*, the excess of interest expense over interest income) exceeds 30% of EBIT.

- Companies having less than € 1 million of net interest expense will be exempt from the "interest barrier".

- An escape provision will be available for taxpayers who can show that their debt-equity ratio is not lower than the ratio of the world-wide group.

- In return, the current thin-cap rules (*i.e.*, limitations on the deductibility of interest on related-party loans) will be abolished.

- Accelerated depreciation of fixed assets (currently 30% can be depreciated on a declining balance) will be abolished.

- The so-called "add-back rules" for the computation of the trade tax base will be amended: Whereas currently 50% of interest on long-term indebtedness is added back, in future 25% of (i) all interest expense and (ii) the "finance portion" of rent, lease and royalty payments will be added back in order to compute the trade tax base.

- Income from the capital investments of private individuals will be subject to a final flat tax of 25% (plus the solidarity surcharge thereon) beginning in 2009 (and not, as under current law, subject to progressive income tax rates of up to 42% plus the solidarity surcharge thereon). This will also apply to private dividends (currently 50% tax-exempt) and private capital gains (currently not taxable if realized outside the speculation period). When a financial institution disburses income from capital investment, the flat tax will be withheld and remitted by such financial institution. Losses from private capital investment will only be deductible against profits from capital investments. The flat tax will apparently not apply to loans between related parties.

- Other important changes relate to the taxation of securities loans, the trafficking with tax losses and the transfer of intangibles or profitable activities offshore.

  - New tax rules for the transfer of "functions" have been announced. The rules will try to tax more effectively the transfer of profitable activities offshore while only routine activities with little or no profit are being retained in Germany. This aims in particular at the transfer of intangible property.

- It is also intended to change the rules for the taxation of securities lending transactions. Under current law, dividends received by the securities borrower are (partly) tax-free whereas the compensatory payments to the lender are deductible. It has not yet been specified what changes will be made to the current rules.

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