

Highlights of German Taxation

In this paper a number of issues are discussed which are particular or of special importance to German taxation. This includes the following subjects:

- The federal system
- Total tax revenue
- Impact of the Constitution and the Federal Constitutional Court
- Global and schedular aspects of income tax
- Determination of taxable business income
- Taxation of corporations and partnerships
- Tax compliance and enforcement
- Tax assessment and tax litigation

1. The federal system

One of the basic characteristics of German taxation is its federal system. Although tax law is more or less uniform within Germany, there are particularities how tax laws are enacted, how tax revenue is split and how taxes are administered.

a) Enacting tax laws

The German Federal Constitution (*Grundgesetz*) of 1949 gives the Federation (*Bund*) the right to enact tax laws if the *Bund* is at least partly entitled to the tax revenues or if federal legislation is necessary to ensure equal living condition or to maintain legal or economic unity in Germany. If the *Bund* makes use of this right, the individual state (*Land*) is no longer authorized to legislate in this area.

Under the federal constitution, the federal states take part in federal legislation through the instrument of *Bundesrat*. Tax laws adopted by the *Bundestag* can be blocked by the states, as is currently the case quite regularly.

b) Sharing of tax revenue

While tax legislation is mainly federal and tax administration is mainly a state matter, the revenue from most of the more important taxes is shared between the *Bund*, the *Länder* and sometimes also the municipalities, e.g. the income tax. The revenue from other taxes is only for the benefit of one level of government, e.g.:

Bund: Customs, most excise taxes (but not beer tax), insurance tax, levies within the scope of the European Community.

Länder: Inheritance tax, beer tax, gambling casino levy

Municipalities: Property taxes

The constitutional revenue sharing is probably the major inroad on the constitutional separation of federal and state budgets.

In addition, there are horizontal payments between rich and poor states; there are also vertical payments from the Federation to individual states.

c) Administrating taxes

When the *Grundgesetz* came in existence in 1949, the Western powers insisted that there was no uniform *Reichsfinanzverwaltung* for the collection of taxes but that taxes were collected by the *Länder*. Today, collection of taxes is decentralized, but uniform.

Conceptually Federal and State tax administration is exercised by a separate hierarchy of Federal and State authorities.

Federal authorities are, in particular, the Federal Ministry of Finance (*Bundesfinanzministerium*) and the main customs offices (*Hauptzollämter*) which are in the field of customs the counterpart to the tax offices. The regional finance offices (*Oberfinanzdirektionen/OFD*) are mixed entities, constituting federal authorities in the customs field and state authorities in the tax field. The head of each regional finance offices is simultaneously a federal and a state government official.

While the constitutional provisions on tax administration may indicate strong differences between the federal states, the reality shows strong uniformity. The general law on tax procedure and on administrative procedural rules are identical as well as career and salary provisions for tax officials. The heads of the regional tax divisions of the federal states meet regularly, together with their federal counterpart. Identical application of tax law is also safeguarded by the *Bundesamt für Finanzen* which sends its auditors in all over Germany to take part in tax audits.

Other than for customs and excise taxes, over the years the *Bund* has expanded its own tax service in certain areas, particularly in that of international taxation. The administrative arm of the *Bund* is the *Bundesamt für Finanzen* which administers refunds of withholding taxes, refunds of VAT, attribution of ID-numbers for EU-purposes, etc.

2. Total tax revenue

In 1999 the total tax revenue of the *Bund*, the *Länder* and the municipalities amounted to DM 886 billion. This number does not include church taxes and social security contributions. In terms of the 1999 tax revenue, the most important taxes are listed in chart 1.

Chart 1: Total tax collection in Germany 1999

Type of German tax listed according to importance	bn. DM	Percentage of total
- Personal income tax (<i>Einkommensteuer</i>), including		
-- Wage withholding tax (<i>Lohnsteuer</i>)	261.7	29.53 %
-- Assessed income tax (<i>veranlagte Einkommensteuer</i>)	21.3	2.40 %
-- Interest withholding tax (<i>Zinsabschlagsteuer</i>)	11.8	1.33 %
-- Other withholding taxes	<u>44.2</u>	4.97 %
Subtotal	339.0	38.23 %
- Value added tax (<i>Umsatzsteuer</i>)	268.3	30.27 %
- Mineral oil tax (<i>Mineralölsteuer</i>)	71.3	8.04 %
- Trade tax on income (<i>Gewerbsteuer</i>)	52.9	5.97 %
- Corporate income tax (<i>Körperschaftsteuer</i>)	43.7	4.93 %
- Tobacco tax (<i>Tabaksteuer</i>)	22.8	2.57 %
- Real property tax (<i>Grundsteuer</i>)	16.9	1.90 %
- Insurance tax (<i>Versicherungssteuer</i>)	13.9	1.57 %
- Car tax (<i>Kraftfahrzeugsteuer</i>)	13.7	1.55 %
- Real estate transfer tax (<i>Gründerwerbsteuer</i>)	11.8	1.34 %
- Customs (<i>Zölle</i>)	6.2	0.70 %
- Inheritance tax (<i>Erbschaftsteuer</i>)	6.0	0.67 %
- Liquor excise tax (<i>Branntweinsteuer</i>)	4.4	0.49 %
- Total of approx. 20 other taxes	15.2	1.72 %
Total tax revenue	886.1	100,00 %

a) Some comments on Chart 1:

The revenue from assessed income tax, corporation tax, inheritance tax appears rather low in an international comparison.

- Assessed income tax has been reduced by several factors.
 - on a permanent basis there are substantial refunds from wage withholding tax effected through the assessed income tax;
 - temporarily, there have been substantial tax-effective write-offs on investment made in Eastern Germany, which not only businesses made use of but also individuals with high income.
- Concerning the low revenue from the corporation tax, in addition to tax-effective write-offs from Eastern Germany, it has to be remembered that many important businesses are still organized as partnerships, and that more and more of the big companies are going more and more global which results in less corporation tax.

About 40 % of local trade tax comes from unincorporated business, 60 % from the corporate sector.

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b) Church tax

Members of the Catholic, Protestant as well as some other churches have to pay a surcharge of 8 or 9 % on the income tax which qualifies as an itemized deduction. The total revenue from the catholic and protestant churches amounted to 17 bn. DM, which is not included in chart 1.

c) Ratio of taxes to GDP

In relation to the gross domestic product the share of the taxes varied only between 23 % and 25 % during the last 25 years. The increasing government burden was mainly caused by an increase of social security contributions.

d) Ratio of direct to indirect taxes

The percentage of direct taxes to total tax revenue developed as follows:

1970:	53.7 %	1990:	57.1 %
1975:	58.9 %	1995:	53.9 %
1980:	58.5 %	1999:	51.9 %
1985:	59.1 %		

e) Social security contributions

German social security contributions currently amount to 41.0 % of wages paid to employees up to certain maximum limits. In 2000 the maximum annual tax base for pension insurance contributions amounts to DM 103.200 in the old German *Länder* and for a obligatory health insurance to DM 77.400. The social security contributions are equally shared between employer and employee.

As of 2000 the social security rates amount to 19.3 % for pension insurance contributions, 13,5 % for health insurance contributions (on average), 6,5 % for unemployment insurance and 1,7 % for care insurance contributions.

3. Impact of the Constitution and the Federal Constitutional Court

Apart from the provisions which concern the powers of different levels of government in taxation, the Constitution had played an important direct role in developing German tax law after world War II. This happened by interpreting fundamental constitutional rights in the tax area.

a) Basic rights

Amongst the "Bill of rights" constituted by articles 1 to 19 GG, the following ones had a special impact on tax matters:

- Art. 2 para. 1 in connection with Art. 20 para. 3 (free development of the individual and due process of law which, for example, prohibit retroactive tax legislation),

- Art. 3 (equality),
- Art. 6 para. 1 (marriage and family are under the special protection of the state),
- Art. 14 (protection of property),
- Art. 19 para. 4 (the right to bring any violation of rights by the administration before an independent court of justice).

These constitutional rights may be directly invoked by the taxpayers.

b) Important decisions

The following decisions of the Federal Constitutional Court had a special impact on taxation:

- the simple fact of marriage may not increase the total tax burden of the spouses; therefore, the joint assessment of husband and wife was declared nil and void; subsequent legislation provided income splitting (1957);
- the income of minor children must be assessed separately (1964);
- the old system of multi-stage sales tax was found unconstitutional, because it gave unfair advantages to integrated multi-state businesses (1966);
- the principle of separation of powers disallows the tax authorities to levy administrative penalties (other than those for late payment) (1967);
- the former system of taxation of interest was unconstitutional because it did not provide for proper enforcement (1991);
- the basic exemption for personal income tax may not be lower than the minimum amount necessary for existence which corresponds to the amount which is paid to the poor by the state welfare authorities. Currently (2001) this is fixed at DM 14.093 per person annually (1992);
- networth tax and inheritance tax have to be changed because the value of real estate was unreasonably lower than the fair market price, which was the value of most other assets (1995);

- the tax burden of families with children is too high because children are not enough tax-wise considered (1998);
- the horizontal payments from rich to poor states (*Finanzausgleich*) should be changed from a cooperative federalism to a more competitive federalism (1999);
- children have to be taken into account for the determination of the care insurance contribution (2001).

c) International Conventions

International conventions such as double taxation treaties need to be transformed to national law through a formal law of Parliament. The transformation of international conventions are of the same quality as any other formal law.

Under the principle of timely sequence (*lex posterior derogat legi anteriore*) subsequently enacted formal tax law is supposed to override a tax treaty which has been concluded and enacted earlier (treaty override, see interpretation by the *Bundesfinanzhof*, BStBl. II 1995, S. 129 on double taxation treaties). Against this view it is argued that the constitution provides that principles of international law are a part of German legal order (Art. 25 GG). *Pacta sunt servande* is one of the principles, to which the Vienna convention on the interpretation of international treaties expressly refers.

4. Global and schedular aspects of income tax

Worldwide, no pure global or pure schedular system of income tax can be found. All systems show aspects of both of the two approaches. In Germany, the existence of several categories of income indicated a certain schedular trait although the general approach seems to be global.

Recent developments during the last ten years seem to go more into the direction of the schedular system. The number of categories of income of which losses are not currently deductible from other categories of income increased and in 1994 even a reduced income tax rate for business income of individuals was introduced. The latest tax reform in 2000,

however, introduced a far-reaching taxation of capital gains of the disposal of privately held property. This indicates a turn-around to a more global approach.

Whereas business income in principle has to be established on the accrual method most other categories of income have to be established on the basis of the cash method.

5. Determination of taxable business income

German taxation of business income earned by both individual entrepreneurs and corporations is marked by a strong reliance of taxable income to accounting income. This linkage (*Maßgeblichkeit*) is based on the principle that the financial accounting treatment has to prevail for tax accounting provided there are no divergent tax provisions. An interpretation by the Federal tax court (*Bundesfinanzhof*) concerned the treatment of accounting options; whenever there is such an option, the taxpayer has to use in his tax return the option which results in a higher taxable income.

This linkage rule, in combination with the absence of express tax limitations has the result that provisions are accepted as tax-deductible deductions in Germany more than in other countries. In spite of higher nominal tax rates, this timing rule gives fast-growing enterprises a temporary tax advantage compared to other countries. On the other hand, mature enterprises suffer under the high tax rates, particularly in periods of high inflation rates.

6. Taxation of corporations and partnerships

a) The importance of partnerships

One of the special aspects of the German economy is the preponderance of unincorporated business in comparison to corporations.

According to trade tax statistics, about 60 % of the revenue from that tax is generated by unincorporated business and only 40 % by corporations. This fact and as a consequence the relationship between the top rate of personal income tax and corporate income tax on retained income used to be one of the most important factors in German tax policy. Until the end of 2000, particularly in the situation with a strong tax competition between the member states of the Community, it was made difficult to further reduce the rate on retained earning

(40 % not including trade tax) because this rate should be comparable to the top rate of personal income tax rate, which was currently 43 % for business income and 51 % for other categories of income (the temporary surcharge of 5,5 % of tax is not taken into account).

The classical instrument of partnership taxation has been the GmbH & Co KG, which is a limited partnership, in which the family members are limited partner and the general partner is a small corporation. From liability point of view this structure is not different from the corporation; however, it provides for personal income taxation of the limited partners. There are approximately 70.000 structures of this type in Germany.

b) Merits of the system

The current imputation system has brought substantial advantages in the purely domestic context because it is a system of full imputation (if one disregards the additional local trade tax which is levied on income). By way of levying corporation tax and dividend withholding tax, the possibilities for tax evasion are very small; in most cases, it does not matter - certainly before the rate reform of 1994 - whether the domestic shareholder declares his dividend income or not. However, the great expectations connected to its introduction in 1977 concerning a rapid expansion of the domestic stock market did not materialize.

There increasing criticism of the full imputation system concerned its cross-border aspects and its probable non-compliance with EC-law and the substantial dividend-stripping of foreign shareholders, which could not be controlled by anti-abuse measures led to a return to classical system with shareholder relief. From 2001 on, corporate income tax is reduced to 25 % (however, trade tax is also levied) and on shareholder level only half of the dividends received by a German resident from a German or foreign corporation are comprised in the tax base. For corporate shareholdings, any dividend income from shareholding in another German or foreign corporation is tax-free on the basis of a comprehensive participation exemption without any minimum shareholding or detention period. Above that also the capital gains arising from a disposal of such, even national, shareholdings is also tax-free.

On the other hand, the tax-haven for thin capitalization was reduced and some other deductions and tax-breaks abolished.

Despite these far-reaching changes, the reform was also heavily criticized, because of its preferential treatment of corporations. In fact, with this reform the old dogma of tax-neutrality of the choice of the legal form is not any more upheld.

7. Tax compliance and enforcement

Like in most tax systems, tax compliance in Germany is better in certain areas than in others. Thus, an area with very poor compliance is taxation of interest received by private investors. On the other hand, as far as business and professional income is concerned, taxes are well enforced by the system of field audits.

a) Tax Audits

Income tax returns have to be checked by a medium level tax inspector (*Veranlagungsbeamter*) before the assessments are signed by a superior inspector (*Sachgebietsleiter*). This desk audit is mainly concerned with plausibility, i.e. reviewing how the different categories of income of the taxpayer have developed compared with earlier years as well as with taxpayers of the same trade or profession etc. The net worth tax returns may be a good instrument for further control.

Field audits are highly developed in Germany. A manufacturing business or a professional firm with annual sales of more than 6,7 million DM (11,8 Million DM in case of a distributor) may certainly expect that a field auditor will arrive after announcement to review its accounting system and its vouchers for an ordinary audit period of the last three to four years. The duration of the audit depends on the size of the business. A professional firm with a turnover of about 50 million DM may expect that the tax audit will last about two to three months. Then, the tax auditor will prepare an audit report and factual and legal discussions will start on single issues. Smaller businesses are audited less frequently; their selection may depend on the existence of certain indications. Altogether, the German tax administration employs more than 10.000 field auditors, who, in 2000, collected a total of Mrd. 26,8 DM of additional tax revenue. In total, about 22 % of all big companies and about 9 % of medium sized companies were subject to a field audit in 2000. Based on this system of field audits, accompanied by severe penalties for tax fraud, in the area of business and professional income tax, compliance appears to be very high in an international comparison.

The same is true for an income from dependent work. Wage withholding is audited in the offices of the employer at shorter intervals (usually one or two years); also smaller enterprises are audited for wage withholding tax on a regular basis. Separately, the payment of social security contributions is field audited by agents of the social security organizations.

The system of field audits is criticized by business because the auditors keep the accountants from doing their regular work. More seriously it is criticized that the audit periods are too long. Quite often transactions are discussed which had happened six or more years ago.

In summary, noncompliance in these areas is certainly below 10 %.

b) Taxation of interest

Taxation of interest earned by private investors is quite different. For many years there was no serious effort to enforce the declaration of interest from bank accounts and bonds. There was no withholding tax on interest, and banks may not report interest payments automatically; the tax auditors of the banks have not been authorized to copy lists of bank customers who receive interest. However, in case of a criminal investigation, the bank has always been obligated to provide full disclosure, likewise in case of death of the tax-payer. Consequently, according to estimates accepted by the Federal Constitutional Court, about 60 % to 70 % of domestic interest received by private investors was not reported. Finally, the Constitutional Court declared the system of interest taxation as unconstitutional because it violated the principle of equal treatment.

Then, in 1993 withholding tax of 30 % was introduced on interest received by residents but not by nonresidents; at the same time a basic exemption for capital income of DM 6.000 per taxpayer, i.e. DM 12.000 for a couple (in 2000 DM 3.000 i.e. DM 6.000), was introduced. Because the withholding tax did only apply to residents, there was a substantial outflow of capital particularly to the subsidiaries of German banks in Luxembourg and in Switzerland, in total more than 500 million DM. Today, it is claimed that also the new system is unconstitutional because it does not safeguard that the tax on interest is fully paid because most taxpayers will have a higher marginal tax rate than 30 %.

There is also a major effort on EU level to introduce a directive for the taxation of interest. However, this directive has been blocked up to now by member states with low interest in that directive, just as Luxembourg and Austria. Above that the directive, for an efficient functioning, also needs the support of tax havens, just like Switzerland. These tax-havens, of course, are rather reluctant to cooperate in that field.

c) Criminal investigations

Compared to other countries Germany has an extremely high number of criminal tax investigations. In my view, it is the fear of a criminal investigation which keeps the rather complicated tax system running. Prominent taxpayers, including executives of major companies are regularly under investigation.

One of the reasons for this situation is the absence of administrative penalties. The interdiction of administrative penalties by the federal Constitutional Court was first regarded as a great victory by taxpayers; in hindsight it may be seen differently.

Every year about 50.000 cases of criminal tax investigations are initiated, of which about 30.000 are terminated by a conviction of tax fraud by a criminal court. The conviction is registered in the criminal records of the taxpayers.

The penalties pronounced by the criminal court are usually monetary; effective imprisonment is rare as far as direct taxes are the cause: prison terms are usually suspended. It is not unusual, however, that a suspect is put into preliminary detention in order to prevent him from disrupting the investigation disappearing to a foreign country. It was already mentioned before that in all of Germany the criminal tax investigation offices have more than 1.000 agents. When a regular tax official, particularly a field agent, is seriously convinced that the taxpayers has acted in a fraudulent way, he has to stop further investigations and transfer the case to the criminal investigation department.

In 1999, almost 8.000 judgements for tax fraud for income taxes were pronounced, with monetary penalties in the amount of 90 Mio DM and detention of in total 1.500 years.

8. Tax assessments and tax litigation

a) Tax assessments

German tax administration works in a quite bureaucratic and formalistic way governed by strict adherence to the rule of law.

All over Germany, more than 200 million tax assessments are made every year. This estimate includes also separate assessments, for example for real estate valuation, partnerships, church tax etc. Some taxpayers may get more than a dozen assessments for the income tax for the same year, taking into account subsequent adjustments and corrections, some of them based on separate assessments for partnerships and civil law associations in which the taxpayer is a member.

A notice of assessments may be appealed within a month (*Einspruch*); this administrative appeal is directed to the same tax office which has made the assessment. Only in rare cases, where facts and legal issues are clear, the taxpayer can go directly to the tax court if the tax office agrees.

The number of appeals against assessment notices is around 8 %. It has to be mentioned that a substantial number of initial appeals (*Einspruch*) are made by taxpayers because they have missed to claim deductions in the tax return or they have failed to file a tax return. Of course, also errors by the tax inspector may be corrected. Experience shows that about half of all appeals filed are accepted for the two reasons explained within a short period.

If the tax inspector does not agree to the appeal, he has to prepare a written reasoning of the rejection to be given to the taxpayers (*Begründung*).

Whether or not an appeal is filed, an assessment will be executed and enforced unless its execution is suspended. This suspension requires a request of the taxpayer based on the existence of serious doubts concerning the correctness of the assessment. Therefore, it is common that the taxpayer files an application for suspension of execution together with the appeal. This application may be filed with the tax office or directly with the tax court.

b) Tax litigation

One month after the receipt of the negative decision on the administrative appeal, the taxpayer may file a suit to the tax court. Tax courts are located in the same cities where there is a regional tax directorate (*Oberfinanzdirektion*). In Eastern Germany new tax courts are currently being built up. There are more than 20 tax courts including East-Germany which employ more than 500 judges.

The tax courts are responsible for both the investigation of the relevant facts as well as the proper application and interpretation of the law.

56.113 new cases came before the tax court in 1994. Over the last years, the number of new cases stayed rather stable but it was about 10 % higher in 1988. The number of the cases which were terminated in 1994 was 63,413. It is interesting to note that only about one quarter of the cases which were terminated were decided by the court. Obviously the time while the case is pending before the tax court is used for negotiations between the taxpayer and the tax administration. The tax courts themselves estimate that in total about one third of the cases terminated end in favour of the taxpayer (the numbers given refer to the situation in the 14 tax courts of Western Germany).

The Federal Tax Court in Munich sits with 11 chambers (*Senate*), each with 5 judges. It is only responsible for the proper application of tax law. Therefore it is not possible for the taxpayer and/or the tax authorities to introduce new facts once the case is brought before the federal tax court unless the tax court has infringed its obligation to ascertain the facts properly.

A case may only be brought before the federal tax court if it is of a fundamental importance. The tax court will first decide whether a case meets this requirement. If the fundamental importance is denied, the taxpayer is entitled to appeal against that decision which has to be first reviewed by the tax court itself and then by the *Bundesfinanzhof* in a short special procedure (so-called *Nichtzulassungsbeschwerde*). Of about 3.000 appeals in 2000, about 20 % were decided in favour of the taxpayer. This percentage would be higher if one takes into account the high number of cases which are rejected for formal reasons.

If a statutory provision is considered to infringe German constitution, the courts must refer it to the Federal Constitutional Court. Taxpayers may submit their case to the Federal Constitutional Court in a special procedure, provided the case otherwise would be finally decided.

In addition, the jurisdiction of the European Court of Justice becomes more and more important. Most cases concern VAT and the interpretation of the 6th VAT directive. Several cases deal also with other tax matters, particularly taxation of nonresident taxpayers.

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