Issues to consider

Germany is a federal parliamentary republic in western-central Europe. It is the largest consumer market in the European Union with a population of over 81 million. Germany is one of the world's largest economies by nominal GDP and ranks at the top investment locations in Europe. Along with its economic stability, Germany is the largest domestic market within Europe, creating a large and stable customer base for investors.

However, there are a number of issues which you must consider when looking to set up your business in Germany. This document takes you through some of the common questions we come across and gives you practical information about the issues you need to consider.

What type of Business Structure should we use?

There are advantages and disadvantages to all of them, and there is not one correct answer, it's all dependent on your specific business circumstances and needs. A brief overview of the main structures is below:

Independent Branch Office (a branch of your overseas business)

- Registered commercial businesses may establish independent branch offices which qualify for registration in the Commercial Register
- Conditions: separate bookkeeping, the manager has certain freedom in managing the branch office
- Not a separate legal entity but an extension of the foreign parent company
- No limited liability or ring-fencing of the German operations
- Profits from the independent branch office are liable to German corporate tax
- EU parent companies must file their company accounts, prepared under the company law of their country (an English version is sufficient), at the Commercial Register for public inspection, even if these are not made publically available overseas

Limited Company (GmbH):

- Provides limited liability and ring-fencing to German operations
- Gives the perception of a local business with longevity
- Only one person is sufficient to set up a GmbH
- A GmbH requires a minimum capital of EUR 25,000
- The "entrepreneurial company at limited liability", which is a simple version of a GmbH, can be founded with a capital of at least EUR 1. In order to achieve the minimum capital of a GmbH, there is an obligation to set aside reserves of a fourth of the annual surplus.
- Articles of association must be notarized. The company's legal existence does not start before the articles of association are published in the commercial register
- The GmbH must appoint one or more managing directors, who can also be

shareholders of the GmbH
- Shares may be transferred by properly notarized documents
- An excerpt of company accounts has to be filed electronically in the electronic German Federal Gazette ("eBundesanzeiger")
- Accounts require auditing as a "medium sized enterprises" if two of the three following conditions are fulfilled for two consecutive years: Revenues > EUR 12m p/a or gross assets > EUR 6m or employees > 50
- Corporation Tax has to be paid on the company's profits

General Partnership (OHG):

- Consists of at least two members (partners)
- No limit is placed on the liability of each partner
- Legal entities may also be members, regardless of whether they were established under German or foreign law
- In principle, the right to represent the general partnership as a whole, can be exercised individually by all partners
- Profits are allocated to members who then pay income tax on these profits personally
- The tax residence of the member, and where the profits in the partnership originated will determine in what jurisdiction and how those profits are taxed

Limited Liability Partnership (KG):

- At least two partners are required, one of which must have unlimited liability and other(s) have liability not exceeding the value of his/ her shares in the partnership
- Legal entities may also be partners. If the only partner with unlimited liability is an entity that has limited liability, indications to this must be made by an appropriate supplement to the company's name, such as the commonly used "GmbH & Co. KG"
- In general, the right to represent the KG is held by the partners with unlimited liability
- Profits are allocated to members who then pay income tax on these profits personally
- The tax residence of members, and where the profits in the KG originated determine in what jurisdiction and what way profits are taxed

How much Corporation Tax will the business pay?

Current Corporation Tax rates in Germany are:

Tax rate (%)	
Corporate Income Tax rate	15%
Solidarity Surcharge	5.5 %, tax base: the corporate income tax
Trade Tax	14%-17% (varies from city to city)

(NB: rates are for the tax year 2017)

Issues to consider

The effective tax rate for corporations typically ranges between 30% and 33% in total.

Group taxation

Tax consolidation for corporate income tax and trade tax purposes (group taxation) requires parent companies to hold the majority of the voting rights of their subsidiary from the beginning of the subsidiary's fiscal year. The parties must conclude a profit and loss transfer agreement, which must be in force and carried out for at least five years, unless an important reason for termination (e.g. sale of the subsidiary). Group taxation is limited to German entities.

Thin capitalization

In 2008 the so-called "interest ceiling" rule came into force, which replaced the former German thin capitalisation rules. Under the interest ceiling rule the deductibility of net interest expenses on all kinds of debt financing (e.g. shareholder, shareholder-related and third party – including bank – financing) is generally limited to 30 % of the taxable earnings before interest, depreciation and amortisation (EBITDA). The 30% limit does not apply if (a) the annual (net) interest burden is less than EUR 3 million; (b) the taxpayer is not part of a group of companies; or (c) under the "group clause", the taxpayer demonstrates that the equity ratio of the German borrower does not fall short by more than two percentage points from the equity ratio of the worldwide group.

Controlled foreign company (CFC)

Germany has controlled foreign company (CFC) rules to consider. A German resident company with more than 50% capital or voting rights of a non-resident company, which is subject to foreign tax of less than 25% and generates so called passive income, is deemed to have a taxable income in Germany out of the profits of this non-resident company. Passive income includes income from renting, licensing or lending of capital.

What if we use Germany to set up our holding company?

Dividends paid to an incorporated enterprise are largely exempted from paying corporate income tax. Merely 5% of the dividends are added to profits as non-deductible operating expenses. This de facto 95% exemption does not apply to dividends paid after February 28th 2013 if the direct participation in the distributing entity is lower than 10% of the share capital at the beginning of the calendar year.

Capital gains arising from the sale of shares by a corporation are also to 95% exempt, regardless of how long the participation in the subsidiary has been held or the extent of the participation. However, there are plans to establish a shareholding threshold, similar to the dividend threshold.

If dividends are derived by a partnership, they are taxed under the "partial income" procedure. Since 2008, 60% of the dividends are subject to the personal income tax of the partners, 40% are tax free.

A non-resident shareholder is able to credit or refund withholding tax on dividends, interest and royalties (depending on Double Tax Treaty and national law). Corporate income tax paid by the company is not credited or refunded.

Withholding tax from dividends paid by a subsidiary with full tax liability to a foreign parent company domiciled in the EU is waived on certain conditions (Council Directive 90/435/EEC), e.g. the parent company has to have a direct holding in the subsidiary of at least 10%.

What if we make cross-border transactions between group companies?

Germany follows internationally recognized Transfer Pricing (TP) rules, where cross-border trading and financial transactions between affiliated entities have to be conducted on an arm's length basis. Prices and terms have to be as if the business transactions are made between completely independent parties.

Businesses have to prepare a transfer pricing report proving the arm's length basis of their transactions. The report includes a functional and risk analysis, analysis of the adopted pricing model and benchmarking of the arm's length basis. For SME's simplifications apply.

An exit tax will be imposed on the "profit potential" that is deemed to be transferred to another country based on the discounted cash flow value of the subsidiary/branch before and after the restructuring.

What Employment Taxes and Social Security will be needed to be paid?

Individuals, resident in Germany, are subject to German personal income tax law. A person is considered resident if either his / hers domicile or permanent dwelling is in Germany.

Personal Income Tax / Wage Tax

German employers have a withholding requirement on monthly wages. Companies that economically bear an individual's wages are also deemed to be a German employer even if no employment contract exists between company and individual (economic employer concept). A permanent establishment according to regulations of the German General Tax Code of a foreign employer in Germany may also be obliged to withhold German Wage Tax. It does not necessarily have to qualify as a permanent establishment under an applicable tax treaty.

Progressive tax rates go from 14 % up to 45%, and a solidarity surcharge of 5.5% on the tax itself, resulting in a top rate of 47.5% is charged. The personal allowance in 2017 is EUR 8,820. Taxpayers, who are members of a church that is recognized for tax purposes, pay church tax at 8 or 9 % of the income tax that is levied.

German personal income tax law allows a considerable number of taxpayer's costs to be deducted from income when computing taxable income. This applies in particular to costs immediately related to earnings. Apart from this, other costs are also deductible, e.g., certain insurance payments or costs incurred by sickness.

Current Social Security rates are:

- Social security pension fund: 18.7% (employee: 9.35%, employer 9.35%)
- Health insurance: 14.6% (employee: 7.3%, employer 7.3%)
- Unemployment insurance: 3% (employee: 1.5%, employer 1.5%)
- Nursing insurance 2.35% (employee: 1.175%, employer 1.175%) plus 0.25 % extra for childless employees over the age of 22

(NB: rates are for the tax year 2017)

It is the employer’s legal obligation to pay the entire social security contributions to the relevant social security agency. The income limit to assessment of the contribution to the pension fund is a monthly salary of EUR 6,200 (= EUR 74,400 p.a.) in Western Germany, EUR 5,400 (EUR 64,800 p.a.) in the former GDR (East Germany), for health and nursing insurance a monthly salary of EUR 4,237.50 (= EUR 50,850 p.a.) in West and East Germany.

(NB: rates are for the tax year 2017)

The employer's share of social security contributions is not considered as taxable income to the employee and the employee's portion is to a certain limit deductible.

Germany has a reciprocal agreement with the USA, EU and many others countries, whereby when foreign nationals of those countries are seconded to Germany for a defined period of time and continue to pay social security in their home country, the employer and employee are exempt from paying German social security contributions.

What is Value Added Tax (VAT) and should businesses be registered?

VAT is a “goods and services tax” on supplies. The standard rate of which is 19%. There is also a reduced rate of 7% for the supply of basic goods (e.g. food) and services (e.g. cultural services). The supply of certain goods and services is without VAT. There is no general threshold for business established outside of Germany.

There are four types of supply

- Taxable supplies – supplier must charge VAT on supplies, and can reclaim input tax
- Exempt supplies – supplier cannot charge VAT nor reclaim input tax (e.g. education, health-care, banks, insurance sector; selling and renting land; some with the right to opt for VAT)
- Zero-rated supplies – supplier cannot charge VAT but input tax deductions are applicable (e.g. export deliveries, intra-Community supplies)
- Outside the scope – not in the German VAT system (e.g. membership fees of sports clubs, supplies by government under certain conditions)

Issues to consider

In general, the person providing the supply of goods or services is the party who owes the VAT and therefore must register for VAT. However, in some cases tax liability passes to the customer or purchaser ("reverse-charge"), e.g. if the taxable person, who is a non-resident and provides services in Germany to a German registered taxable person.

VAT is incurred at the end of the reporting period during which the taxable supply of goods or service was provided. The amount payable is the VAT due minus the input tax which may be deducted. Larger and new established businesses have to submit an advance return every month. At the end of the calendar year the taxable person has to submit an annual VAT tax return in which it again has to calculate their taxes.

Can we provide Share option plans to our staff?

Many companies see share option plans as being an important way of attracting, motivating and retaining key staff. In Germany it is possible to give (small) tax benefits to employees if they become shareholders. However this is a very complex area and careful planning needs to be undertaken as soon as share option plans are considered for implementation in Germany.

How else can we compensate our employees?

Germany has a very comprehensive range of compensation and benefit options available for companies to offer their employees. But unfortunately most of them increase the taxable income (non-cash benefits). If certain conditions are met, rental costs incurred for the employee, meal allowances and commuting expenses can be reimbursed tax-free.

To discuss your requirements please contact the International Office on +44 (0) 1245 449266 or email us directly.

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Issues to consider

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The information in this document was prepared as of February 2017.