



Insights



10 tax issues to consider when doing business in Germany

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Germany is the largest economy in Europe and one of the most important markets in the world. The interest for foreign companies who want to sell products or provide services in the German market is steadily growing in recent years. In addition, German business entities are regularly a target of foreign business investors.

In any case, foreign companies and investors have to consider the complex German tax regulations in order to avoid unnecessary risks.

The following 10 tax issues should be considered when planning to enter into the German market.

1 Different forms of business engagements in Germany

Engaging in business in Germany can be done in various forms. Foreign based businesses can decide to sell their products or services directly without a legal or physical presence in Germany.

If a local presence is required, foreign businesses or investors can decide to set up a local legal entity. Often foreign companies report that engaging with business partners, suppliers, public institutions, and banks on the German market generally is easier, if a German company is established. German corporate law distinguishes between corporations (UG, GmbH, AG) and partnerships (OHG, KG). Foreign businesses often choose to set up a corporation in the legal form of a GmbH.

Existing foreign companies can also conduct business via a German branch office / permanent establishment.

The German taxation generally reflects the distinction between corporations and partnerships. While corporations are treated as a separate legal entity for tax purposes and are subject to German corporate tax and trade tax, partnerships are treated as transparent for tax purposes. The income of a partnership is taxed based on the characteristics of its shareholders. If the shareholder is a corporation, the attributable income of the partnership is taxed on the level of the shareholder with corporate income tax. The partnership itself is subject to trade tax, provided the entity engages in a trade or business.

The taxation of a German branch office / permanent establishment is also dependent on the tax characteristics of the respective parent entity. When choosing the appropriate form of business in Germany, in addition to the German domestic tax law, also the relevant double tax treaty and its provisions must be considered.

2 Tax compliance obligations in Germany

Doing business in Germany results in various tax compliance obligations.

Direct sales from abroad into Germany without a physical or legal presence in Germany are only subject to minor compliance obligations. These obligations increase significantly however, if the foreign business constitutes a physical or legal presence in Germany. Such a presence is constituted if a permanent establishment or a legal form of corporation or partnership in Germany is established. Note, that a permanent establishment does not necessarily have to be actively setup, but can be constituted 'accidentally' by certain actions.

The resulting compliance obligations typically include:

- Upon establishment, registering the entity or permanent establishment for tax purposes in Germany
- VAT filings (monthly, quarterly, annually)
- Wage tax filings (monthly)
- Social Security filings (monthly)
- Tax filings (annually; Corporate Income Tax, Trade Tax, Value Added Tax)

In addition, other compliance obligations can arise dependent on the nature and form of business activity in Germany. These can relate to transparency obligations, customs filings, Interstat reports etc.

3 Taxation of corporations in Germany

Corporations are considered separate tax subjects and are therefore taxed irrespective of their shareholders and the shareholders characteristics.





Corporations such as a GmbH are subject to the following taxes on profits in Germany:

- Corporation Income Tax
- Solidarity surcharge
- Trade Tax

These taxes also apply for non-resident companies, which are considered corporations, with a permanent establishment or a permanent representative in Germany. The profits attributable to the permanent establishment will be subject to German taxes and the applicable compliance requirements must be met.

The corporation income tax rate is a linear tax rate of 15%. In addition, a solidarity surcharge of 5.5% of the corporate income tax is levied.

Corporations are considered to constitute a trade or business based on the legal form and irrespective of the nature of their actual activity. Therefore corporations are also subject to trade tax which varies depending on the municipality they are registered in between approximately 14 % to 17%.

4 Dividend distribution: Taxation of foreign shareholders

A decisive factor for foreign investors are the tax implications arising from the taxation of profit distributions of their local Germany subsidiary in the form of a corporation.

For foreign shareholders of a German company the following applies:

- If the foreign shareholder is a tax resident of a country, which has no double taxation treaty (DTT) with Germany, the shareholders are subject to a 25% withholding tax plus solidarity surplus charge. This tax is not refundable and therefore definite. This applies for foreign companies as well as for individuals.
- If the foreign shareholder is a tax resident of a country, which has a DTT with Germany, foreign companies may be subject to a German withholding tax of 0% to 10% (depending on the treaty). This provision is applicable for so called qualified participants.
- If the shareholder is a corporation and a tax resident of an EU member state, the EU parent-subsidiary-provision may apply, thereby reducing the withholding tax on profit distributions to 0%
- In all other DTT-cases (non-qualified distributions to companies and contributions to individuals) the withholding tax rate is 15%.
- Generally, German withholding taxes can be credited against the foreign income tax in case there is a DTT. Some jurisdictions do not tax dividends (profit distributions) at all. However, in general this tax-free status will result in the denial of a tax credit, which means that the German withholding tax becomes definite.
- In addition, note that generally profit distributions are subject to the statutory German withholding tax of 25% plus solidarity surplus charge (total tax rate 26.375%), despite the reduction of the withholding tax rate based on the respective DTT.

The foreign shareholder can apply for a certificate of exemption ("Freistellungsbescheinigung") before the dividend is paid out. In this case, the distributing German company is able to pay out the dividend without withholding tax. Without certificate of exemption, an application for the refund of the difference can be filed at a later stage.

Both applications have to be made with the federal central tax office ("Bundeszentralamt für Steuern"). The foreign shareholder must prove that he or she is a tax resident in the other country and registered there for tax purposes.

5 Capital gains

Capital gains arising from the sale of assets are generally taxed as regular ongoing income, subject to the standard profit taxes. For certain assets, there are tax incentives to avoid the immediate taxation of the arising profits and transferring these to newly acquired assets.

In addition, capital gains derived by corporations from sales of shares in corporations are generally exempt from corporate income tax and trade tax. Five percent of the capital gain is however deemed a non-deductible expense. As a result, the exemption is effectively limited to 95% of the capital gain. Based on case law, the 5% deemed expense add-back should not apply to non-resident corporate sellers, even if the non-resident seller cannot claim treaty protection.

If the shareholder is an individual, capital gains will only be taxed if the shareholder owns more than 1% of the shares.

Capital gains may also arise, if certain legal transformation transactions such as mergers, demergers, change of legal form etc. are conducted, as these can be deemed to be equivalent to a sale of shares or participation. However, the German restructuring tax law allows the tax neutral transfer if certain formal requirements are fulfilled, and the restructuring process does not result in a loss or restriction of the right of Germany to tax profits or capital gains in the future.

The same applies for exits. This is the case if the place of management of the German company is relocated to another country, or an individual gives up his or her main tax residence in Germany.

Similar rules apply if a German permanent establishment is sold, terminated, or transferred into another legal form such as a German corporation.

There are special provisions in double taxation treaties with regards to capital gains.

6 Transfer pricing regulations

As many other countries, Germany has special transfer pricing regulations. These provisions apply to transactions between a German company and its foreign shareholder or subsidiaries. All cross-border transactions between related parties have to be in line with the arm's-length principle. The arm's-length principle is the core element of the German transfer pricing legislation as outlined in Section 1 (1) of the Foreign Tax Act. Transactions between related parties have to be priced in a comparable manner as transactions with unrelated parties.

In practice, the determination of a fair market price can be difficult if there is no sufficient market data available of transactions between third parties.

Similar rules apply for the profit-split between a foreign headquarter and its German permanent establishment.

The documentation rules in Germany for transactions between related parties are extensive and the various transfer pricing documentation requirements apply, depending on the revenue.

In addition, Germany also has unique tax regulations for the transfer of business functions (e.g. production, sales, marketing, research and development etc.) from Germany to another jurisdiction. The cross-border relocation of functions can result in an exit tax.

With an increase in international trade, transfer pricing has become a focal point of tax audits in recent years. While the local tax authorities are responsible for conducting tax audits, there are expert tax auditors, specialized in transfer pricing. These experts are typically included in the audit team whenever a transaction involves a significant business relationship with a non-German affiliate.





Mistakes in the transfer pricing as well as shortcoming in the documentation obligations can result in significant tax risk.

For a detailed overview regarding the German transfer pricing legislation refer to our OnePager on the German transfer pricing regulations.

7 General interest expense limitation rule

The German tax law generally allows the deduction of interest expenses. However, there is an interest expense limitation provision, restricting the deductibility under certain circumstances.

The interest expense limitation rule generally applies to all loans - that is, group and third-party loans. The provision also applies to businesses resident in Germany, companies residing abroad but maintaining a permanent establishment in Germany, as well as partnerships with a German branch.

Under the German interest expense limitation rule, the deduction of interest expense exceeding interest income (net interest expense) is limited to 30% of taxable earnings before (net) interest, tax, depreciation and amortization (EBITDA).

The limitation rule does not apply if the annual net interest expense is less than EUR 3 million (=exemption threshold). Also, the limitation provision can be avoided, if the company is not a member of a consolidated group and the net amount paid to any one shareholder of more than 25 % (or a related party) is no more than 10 % of the total (= group clause) or if the equity ratio of the German subgroup is at least as high as the equity ratio of the worldwide group (within a 2% margin; escape clause).

Unused EBITDA can be carried forward over a five-year period. Also, nondeductible interest expense can be carried forward indefinitely but is subject to the loss-deduction limitation rules.

8 Value added tax

Germany, as all EU-member countries, levies a Value Added Tax (VAT) on transactions. As a sales tax, the VAT is levied at all levels of taxable supplies of goods and services made by a taxable person in the course of any business activity carried on in Germany and on the importation of goods from other states.

The standard VAT rate is 19%, however, there are specific types of goods for which different rates apply. All products that do not explicitly fall under the reduced tax rates of 7% or 0% are taxed accordingly at 19%. There are also tax-free (or zero-rated) supplies e.g., services of banks, insurance companies, insurance brokers, doctors, hospitals, and certain services in the field of education, research etc.

In Germany VAT must be reported to the local tax authorities on a monthly or quarterly basis (VAT advance notifications, "Umsatzsteuer Voranmeldungen") and additionally on an annual basis (VAT annual return, "Umsatzsteuerjahreserklärung"). Where input tax paid can be offset against output tax received, only the balance has to be paid. If input tax exceeds output tax, a refund may be obtained. Special rules apply if a taxable person makes both taxable and non-taxable supplies, which have the effect of restricting the input tax relief to the taxable element of supplies received.

There are detailed rules controlling the recording and processing of German transactions for VAT purposes. These include guidelines on:

- German invoice requirements
- when to issue a German tax invoice
- foreign currency reporting
- credit notes and corrections
- correcting entries from prior returns
- what accounting records must be maintained.

VAT in particular can be a major tax liability issue. The fiscal authorities in Germany are very strict in respect to VAT. We are happy to assist you with your ongoing VAT filing requirements and resolving any questions or issues that may come up in this respect.

9 Customs and excise taxes

Customs regulations are harmonised in the European Union (EU) as all member states, including Germany, form a customs territory - the European Customs Union - in which unified customs arrangements apply.

Therefore, goods imported into the EU are subject to EU-wide import regulations, customs tariffs, and customs procedures. Customs duties are only levied when the goods are imported into the EU. No further customs duties must be paid within the customs territory once goods have been imported into the EU - even in cases where the goods cross internal borders of member states.

Therefore, any import and export is (at least in principle) subject to the same regulations in all EU member states. In Germany customs are administered by a special customs authority. Customs authorities are also responsible for other issues such as export control and excise taxes.

In order to participate in customs procedures, an EORI number ("Economic Operators Registration and Identification" number) - amongst other things - is required. Easements in customs procedures may derive from obtaining an Authorized Economic Operator (AEO) status.

More information on how to apply for an EORI number is available on the German customs authority's website.

EU customs law is very restrictive. Therefore, companies have to make sure that they follow the appropriate customs' regulations at all times and in detail.

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doing business
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10 Employees: Social security and wage taxation

Employing staff in Germany results in certain strict compliance regulations.

To be able to employ staff an active tax number for payroll must be available. In addition, the social security providers require an employer identification number (EIN, "Betriebsnummer"). Before hiring your first employee in Germany you therefore must apply for an EIN, which allows you to pay the required social insurance contributions. This number must also be used in all communications with health insurance companies and the DRV (German statutory pension insurance scheme). The EIN must be applied for at the Federal Employment Agency ("Bundesagentur für Arbeit").

Employers must uphold the German wage tax and social security obligations.

Employers situated in Germany have to withhold the wage tax from the gross income of their employees. They have to file a monthly tax return and have to pay the tax withheld to the local tax office. Further, formal requirements such as filing payroll accounts for every employee, extensive documentation requirements have to be fulfilled and the employers are subject to audits by the tax authorities.

If a foreign employer has no establishment in Germany but employs staff in Germany, the foreign business entity is not deemed to be a "German employer". In this case the entity is not entitled to file monthly tax returns and is not able to deduct and transfer the wage tax on behalf of the employee to the fiscal authorities. In this case, the employee has to file an annual income tax return and has to pay the income tax in instalments.

Social security contributions have to be paid by the employer and employee in equal shares. The employee's share has to be withheld by the employer and to be paid together with the employer's share to the relevant social health insurance agency. Every employer is obliged to file monthly social security declarations and to fulfil certain formal obligations.

Unlike in other countries, income taxation of employees (wage tax issues) and social security affairs are totally separated from each other. While the taxation is administered by local tax offices, social security issues are administered by official social security agencies. This results in a quite complex situation with regards to payroll accounting.

The required monthly payroll filings must be filed in due time.

It's highly recommended to utilize a payroll service. We are happy to help you with these payroll services. Our payroll team will be happy to take care of all ongoing compliance issues and help to guide you through issues that may arise when employing staff or dealing with a wage tax or social security audit.

We are here to help.

With over 20 years of experience in guiding foreign based entities and investors into the German market, we are efficient and pro-active in assisting you in setting up your German GmbH.

Get in touch with us.

