Setting up your Business in Germany
Issues to consider

Germany is a federal parliamentary republic in western-central Europe. Germany is the largest consumer market in the European Union with a population of over 82 million. Germany is the world's fourth-largest economy by nominal GDP and the fifth-largest by purchasing power parity. As a global leader in several industrial and technological sectors, in 2012 it was the third-largest exporter and third-largest importer of goods. The economy took a serious hit during the economic crisis, but recovered quickly. The labour market remained resilient during the economic crisis and continued to be strong in 2011 and 2012.

However there are a number of issues which you must consider when you are 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 no 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 (Companies House)
- Conditions: own possession, separate bookkeeping plus the manager has certain freedom in managing the branch office; decisions will be made according to the situation of each case
- Not a separate legal entity but an extension of the overseas parent company
- No limited liability or ring-fencing of the German operations
- Profits from this Independent Branch Office are liable to German Corporation tax
- EU parent companies must file their **parent company accounts**, prepared under the Company Law of its statuary seat (an English version is sufficient), at Companies House 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 a perception of a local business, with longevity
- Required minimum capital is EUR 25.000 and can be made in kind
- 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, but in order to achieve the capital of a GmbH one day, there is an obligation to set aside reserves of a fourth of the annual surplus
- Registration in the Commercial Register required

- Corporation tax to be paid on company profits
- Corporate tax returns are due by 31st May of the following year
- Accounts require auditing as a medium sized enterprises if two of the three following condition are fulfilled: Revenues > EUR 9,68m p/a or gross assets > EUR 4,84m or employees > 50
- An excerpt of company accounts have to be filed electronically at Companies House ("eBundesanzeiger") for public view

General Partnership (OHG):

- Must consist 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, may 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 these profits are taxed

Limited Liability Partnership (KG):

- At least two partners are required, one of which must have unlimited liability and one of which must 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 the member, and where the profits in the KG originated will determine in what jurisdiction and how these profits are taxed

How much Corporation Tax will the business pay?

The current Corporation Tax rate in Germany is 15%. Additionally a Solidarity Surcharge of 5.5% is levied on the corporate tax due.

Corporate income from trade or business is also subject to Local Trade Tax. The Local Trade Tax rate depends on the individual rate of the municipality, where the company is established, and the federal multiplier of 3,5%. The current multiplier for example for Berlin is 410%, for Frankfurt am Main 460% and for Stuttgart 420%. The actual trade tax burden can be calculated to be approximately 14% to 17%.

The effective tax rate for corporations typically ranges from 30% to 33% in total.

Tax consolidation for corporate income tax and local trade tax purposes (**group taxation**) requires that the parent in the consolidation holds the majority of the voting rights in the 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 exists for termination of the agreement (e.g. sale of the subsidiary) before the end of the five-year period.

If the partners of Partnership are individuals the Personal Income Tax rules apply (see below).

Thin capitalisation

In 2008 the so-called "interest ceiling" rule came into force, which replaced the former German thin capitalisation rules. Under the interest ceiling rules 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).

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 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 the rental of real estate, income from licensing or income from the 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 corporation tax. Merely 5% of the dividends are added to profits as non-deductible operating expenses. The same applies if a taxable corporate enterprise sells shares in another company.

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); corporation tax paid by the company is not credited or refunded.

The withholding tax from dividends paid by a subsidiary with full tax liability to a foreign parent domiciled in the EU is waived on certain conditions (Council Directive 90/435/EC), 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. The price and terms should be the same as if the transactions had been between completely independent parties.

A business will need to prepare a Transfer Pricing Report proving the arm's length basis of transactions. The report will include a functional and risk analysis, analysis of the adopted pricing model and benchmarking of the arm's length basis. SME's are generally exempt from the transfer pricing regime.

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

If an individual is resident in Germany they are subject to German Personal Income Tax Law. An individual is resident if either its domicile or its permanent dwelling is in Germany.

Personal Income Tax / Wage Tax:

The German employer has a withholding requirement. A company that economically bears an individual's wages is also deemed to be a German employer even if no employment contract exists between the German company and the 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.

Rates are progressive from 14 up to 45% and a solidarity surcharge of 5.5% resulting in a top rate of 47.5%. The personal allowance is EUR 8,130.00. If the taxpayer is a member of a church that is recognized for tax purposes, church tax at 8 or 9 % of the income tax is levied. Non-resident employees are also subject to income tax at graduated rates as well as a solidarity surcharge. But, they are not subject to church tax.

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: 18.9% (employee: 9.45%, employer 9.45%)
- Health insurance: 15.5% (employee: 8.2%, employer 7.3%)
- Unemployment insurance: 3% (employee: 1.5%, employer 1.5%)
- Nursing insurance 2.05% (employee: 1.025%, employer 1.025%)

(NB: rates are for the tax year to 31/12/2013)

It is the employers' legal responsibility to pay over employee's tax and social security deductions to the German tax authorities. The income limit to assessment of the contribution to the pension fund is a monthly salary of EUR 5.800 (= EUR 69.600 p.a.) in Western Germany, EUR 4.900 (EUR 58.800 p.a.) in the former GDR (East Germany), for health and nursing insurance a monthly salary of EUR 3.937,50 (= EUR 47.250 p.a.) in West and East Germany, i.e. contributions are calculated from maximally this amount.

(NB: rates are for the tax year to 31/12/2013)

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

Germany has a Reciprocal Agreement with the USA, EU countries and many others whereby when an overseas national of those countries is seconded to Germany for a defined period of time and continues to pay social security in their home country, then the employer and employee are exempt from paying German social security contributions.

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

VAT is a "goods and services tax" on supplies made, the standard rate of which is 19%; the reduced rate is 7%. The supply of certain goods and services is VAT exempt. If a business established in Germany makes taxable supplies in excess of EUR 17.500 in any 12 months then it MUST be registered for VAT. There is no general threshold for business established outside Germany.

There are three types of supply

- Taxable – must charge VAT on supplies, can reclaim input VAT
- Exempt – cannot charge VAT nor reclaim input VAT
- Outside the scope – not in the German VAT system

The supply of most types of goods and services in Germany would be classed as taxable supplies. However when these supplies are made to companies which are outside of Germany advice needs to be sought as to what rate of VAT, if any, to use.

If a German entity sells goods or provides services to its non EU parent then there is no VAT chargeable on this overseas supply, however on the basis that the supply would be VAT'able if made in Germany then the entity will be able to reclaim all its input VAT.

In general, the person providing the supply of goods or services is the party who owes the VAT and therefore must register for VAT. In some cases however, the tax liability passes to the customer or purchaser ("reverse-charge"), e.g. if a taxable person who is not resident in Germany provides services in Germany for a German registered taxable person.

The 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 VAT 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 the tax itself.

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.

Germany has a number of "approved" share option plans which give tax benefits to employees and employers alike and it is often possible to adapt an overseas stock option plan to fit into one of these "approved" plans.

However this is a very technically complex area and careful planning needs to be undertaken as soon as share option plans are being 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 of the employees (non-cash benefit). If certain other conditions are met, rental cost 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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