

# **SETTING UP BUSINESS**

## **In Germany**

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## Preface

Foreign Investment into Germany has increased significantly in recent years. A lot of foreign corporations and companies in other countries have selected Germany as the base for their operations. Germany has also attracted high levels of investment from European countries, not least from European multinationals virtually all of which have substantial operations in Germany.

Germany is a country surrounded clockwise from north to west with probably the most neighbours in the world: Netherlands, Denmark, Poland, Czechoslovakian Republic, Austria, Switzerland, France, Belgium, Luxemburg.

Overseas investors are warmly welcomed by Germany and receive equality of treatment with German owned enterprises. There are a lot of foreign associations e.g. the American Chamber of Commerce Germany which has 3000 members ([amcham.com](http://amcham.com)) is one of biggest. Basten Eberle GmbH is a member of AMCHAM.

This memorandum is a brief introductory guide for foreign enterprises considering the expansion of their activities into Germany. It is not an exhaustive commentary and professional advice should be sought before any decisions are made.

Basten Eberle GmbH is also a member of the Alliot Group, a worldwide network of independent professional service firms dedicated to delivering superior accounting, business and financial advice to clients through our global network in over 60 countries.

The Rhine-Main-Region is situated in a very central area and is Germany's most cosmopolitan region. In many international benchmarkings Frankfurt Rhine-Main-Region fetches top rankings and is clearly among the most appreciated business locations in Europe.

**These notes are for guidance only and professional advice should be obtained before acting on any information contained herein. Basten Eberle GmbH cannot accept any responsibility for any loss occasioned to any person as a result of action taken or refrained from in consequence of the content of this note.**

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# **SETTING UP BUSINESS IN GERMANY**

## **I. THE COUNTRY AND ITS GOVERNMENT**

### **1. Description of the Country**

The Federal Republic of Germany has approximately 83 million inhabitants and is made up of 16 states. These federal states, or Bundesländer, have their own legislative, executive and judicial powers. They are largely responsible for educational and cultural policies, the implementation of most national directives and laws and are masters of their own administration. Information on each individual state, as well as key contact addresses for potential investors are available at [www.invest-in-germany.com](http://www.invest-in-germany.com).

### **2. Language**

The language of Germany is German although in certain parts of South Germany the Bavarian accent is in common usage. Besides, Low German (Plattdeutsch) is for instance used in the North of Germany (between the Netherlands and Denmark).

### **3. Government**

Germany is a parliamentary, federally organized democracy. The German chancellor heads the executive branch of the German federal government. The duties of the president are largely ceremonial. Elected by and accountable to the Bundestag tower house of parliament, the chancellor cannot be removed from office during a four-year term unless the Bundestag has agreed on a successor. The Bundestag is elected for the same four-year term and currently includes 668 delegates. The Bundesrat upper chamber of parliament consists of 69 delegates from the 16 federal states. Germany has an independent federal judiciary consisting of a constitutional court, a high court of justice and courts with jurisdiction in administrative, financial, labour and social matters.

Although the Bundestag bears the main responsibility, the federal government and parliament, as well as the 16 federal states and thousands of local authorities collectively share legislative powers. This has an impact at all levels of economic policy-making, for example, in terms of the need for binding budgetary rules on revenue sharing, taxation and borrowing powers. The states are involved in policy-making through their representation in the Bundesrat. The Bundesrat must concur on bills treating revenue shared by federal and state governments and those imposing responsibilities on the states. Germany's federal system of government therefore creates by its very nature a problem of power sharing between the federal and state governments, a problem that is highlighted by the ongoing dispute over revenue sharing between wealthier and poorer federal states and the federal government's role in this system.

#### **a) Legislative Branch**

Legislation, in the first instance, is presented to Parliament in the form of Bills which, to become law, have to be approved by both Houses of Parliament. In the event of dispute the Bundesrat can stop Bills. A Bill becomes law by becoming an Act of Parliament when it has formally announced in "Bundesgesetzblatt".

Local Government is administered by locally elected Councils and is divided into County Councils and certain Borough Councils or District Councils in Metropolitan areas.

Local authority is financed from central Government but also from a Trade Tax on businesses known as "Gewerbesteuer" and a charge on individuals based on property values known as the "Grundsteuer".

Germany is a member of the European Union (EU) and therefore subject to legislation or directives imposed by the EU.

#### **b) Judicial Branch**

The courts in Germany are divided into five independent branches and a distinction is made between ordinary and specialized jurisdiction. Ordinary jurisdiction covers the civil and criminal courts, whereas specialized jurisdiction relates to administrative courts, social courts and finance courts.

In all branches jurisdiction there are federal and land (state) courts. There are several instances, i.e. levels of court proceedings. There is usually a three-tier system with the first two instances being courts of the Länder, while the last and the highest instance is a federal court. The three levels of the ordinary jurisdiction are the local court (Amtsgericht), the regional court (Landgericht) which may be the first or second instance depending on the importance of the case, the higher regional court (Oberlandesgericht) and the Federal Court of Justice (Bundesgerichtshof).

The Federal Constitutional Court (Bundesverfassungsgericht) is both a court and a constitutional organ. According to § 1 (1) of the Federal Constitutional Court Act (Bundesverfassungsgerichtsgesetz), the court is an independent court of justice of the Federation. The Federal Constitutional Court ensures that parliament, government and the judiciary abide by the constitution. As the guardian of the constitution it has the right to examine any act by the legislature, the executive and the judiciary, as well as all court decisions, as to their constitutionality.

This supreme court not only protects the constitution but is required to make binding interpretations of the Basic Law (Grundgesetz). This is because a constitution contains only principles and rules expressed in general terms. It therefore constantly requires interpretation in the light of social change.

#### 4. Advantages of the Country

- a) Germany is the biggest industrial country in Europe, a net exporter of cars, machinery, chemicals and manufactured goods. Frankfurt, is still one of the principal financial centres of Germany. Taxation is moderate for both corporations and individuals.

b) **German Values and Behaviour Patterns in Business**

Germany is one of the most successful and envied economies of the second half of the twentieth century. Companies have achieved success by hard work and efficiency, both highly valued character traits. The quality of products is recognised throughout the world. Organisation is tight and precise (well ordered), everybody knows his or her function. Decisions are made after careful, thorough and precise analysis. Risks are minimised; security is a lifeline. Time schedules are strictly adhered to: Punctual delivery means on the day precisely! Formality is a necessary sign of respect. Business is serious business. These are values that pervade society and are the foundation on which German managers build.

c) **Ranking of Germany's most Important Trading Partners (in 2001)**

Ranking of Germany's trading partners (in 2001)	
Imports from (in € billions)	
France	51.67
Netherlands	46.28
United States	45.45
Britain	38.20
Italy	35.67
Exports to (in € billions)	
France	70.67
United States	67.30
Britain	53.27
Italy	47.51
Netherlands	39.29
Source: Federal Statistics Office Germany	

#### 5. Currency

The monetary unit used throughout Germany is the Euro (€), divided into 100 cents. Germany is a member of the Euro zone.

## **II. BUSINESS ORGANISATION**

### **1. Basic Legal Conditions in Germany**

Many foreign companies, entrepreneurs and employees play an active role in German economic life, and there are good reasons for this foreign presence. Germany presents an investor-friendly environment with liberal laws for forming different types of business structures. Unlike some other countries, Germany imposes no specific laws regulating foreign investment or real estate ownership and makes no requirements of German participation in business ownership or management. Foreign investors can freely transfer dividends and interest abroad-often without paying German tax. These and many other factors make Germany a friendly host to foreign investors.

#### **a) The Commercial Register (Handelsregister)**

The Commercial Register provides clear public information about the legal status, relationships and the business situation of companies. Registration in the Commercial Register is essential for establishing specific forms of businesses. Registration in the Commercial Register constitutes legal formation with regard to these companies, which gain their legal identity only through this registration process. The Commercial Register is recorded by applicable local courts.

#### **b) Municipal Authority Trading Register**

All kinds of trade and services require formal registration at the municipal authority (Gewerbeordnung).

#### **c) Tax Office Registration**

All kinds of business require formal registration at the tax authority (§§ 134-139 General Tax Code).

### **2. Kinds of Organisations**

- Direct investment
- Sole proprietorship
- Representative office
- Branch office
- Partnerships
- Corporate entities

#### **Organisational Overview**

Some foreign companies may want to participate in the German market without establishing or acquiring an enterprise in Germany. These investors can do their business in Germany in a number of different ways, including direct investment, sole proprietorship, or founding a representative or branch office.

➤ **Direct Investment**

Every foreign person or company can actively be involved in the German economy without restrictions or limitations as long as business is done from abroad.

➤ **Sole Proprietorship**

A sole proprietorship is the business of one person. Every person who is competent to do so can found a small commercial enterprise. In general there are no formal or administrative requirements for founding a sole proprietorship. However it is generally best if the sole proprietor registers her business in the Commercial Register. For some special kinds of businesses an administrative certificate is required. A trading licence is necessary in some other cases. Some specific professions also set exacting standards for qualification, e.g., for attorneys. In any case, the company's name must be characteristic and distinctive.

➤ **Representative Office (Repräsentanz)**

The next step is to develop a personal presence in Germany after doing business from abroad, could be the establishment of a representative office. Representative offices (Repräsentanzen) are not considered to be engaging in trade or business, but merely establishing a presence in Germany to facilitate German interactions with its offices abroad.

➤ **Branch Office (Zweigniederlassung)**

If the company actually wants to “do business” in Germany, it must go beyond a representative office. When establishing real commercial operations, a foreign investor can decide between opening a branch office in Germany or founding a separate German company under German law.

The exact term “branch office” is not defined by German law. However one can speak of a branch office where a commercial entity establishes a physically separate facility which is managed by the parent company. Generally, branches of a foreign must be registered in the Commercial Register of the court with jurisdiction over the branch office. A branch office does not become a legal entity through its independence or registration. Rather, it remains a dependant part of the mother company under German law. However, the enterprise can sue and be sued in the name of the branch office and at that office's place of establishment.

➤ **Partnerships**

Any kind of business can be pursued through partnerships. However, partnerships have no legal identity of their own. Due to the unlimited liability of partners, foreign investors in Germany rarely use these forms. Civil Law Partnership, General Partnership, Limited Partnership are the most important forms of partnerships in Germany.

**Civil Law Partnership – Gesellschaft des Bürgerlichen Rechts (GbR)**

The civil law partnership is regulated in the German Civil Code (Bürgerliches Gesetzbuch); it is defined as an association of individuals or enterprises to achieve a joint contractual purpose. Self-employed persons, such as lawyers and accountants often choose this form in order to found their professional firms (Sozietäten).



### **General Partnership - Offene Handelsgesellschaft (OHG)**

The basic structure for a general partnership can be found in the German Civil Code's rules about civil law partnerships, which also apply to general partnerships. The difference between a general partnership and a civil law partnership is that the general partnership is doing trade and is therefore a commercial entity.

The general partnership is an organisational form, in which each of the general partners has unlimited personal liability for all activities of the company. It is possible for the general partnership to conclude contracts, possess real estate and to sue or be sued under its company name.

### **Limited Partnership – Kommanditgesellschaft (KG)**

A limited partnership has at least one partner with limited liability, the “limited partner” while at least one other partner is a general partner with unlimited personal liability. The liability of the limited partners is restricted to their share of the partnership capital. Although a limited partnership does not have its own legal identity, it can conclude agreements under its own name and it can sue or be sued. It is also possible to establish a hybrid form between a limited partnership (KG) and a limited liability company (GmbH). This hybrid form is called a “GmbH & CoKG”. It is a limited partnership where the general partner is a limited liability company.

## **➤ Corporate Entities**

### **Limited Liability Company - Gesellschaft mit beschränkter Haftung (GmbH)**

The limited liability company is the most common organisational form in Germany. The procedures required to establish and operate a limited liability company are much less comprehensive and expensive than those for a corporation.

The limited liability company is by the Law Concerning Limited Liability (Gesetz betreffend Gesellschaften mit beschränkter Haftung). A limited liability company is always a commercial entity and a legal person. One or more persons or companies can found a limited liability company by concluding an organisational agreement. The limited liability company exists as soon as it is registered in the Commercial Register.

The transfer of membership interests in a limited liability company requires certification by a notary and must be brought to the attention of the company and noted in the Commercial Register. Since January 1, 1999, the minimum share capital of a limited liability company is set at € 25,000.

A limited liability company must have two organs: Membership Meeting and Managing Directors. The establishment of a Supervisory Board is required only if the limited liability company has over 500 employees. The membership meeting is the highest organ of a limited liability company. The organisational agreement governs the membership meeting. However, the membership is always required to be responsible for the following issues: changing the organisational agreement, changing the share capital, requiring additional capital contributions and dissolving the limited liability company.

The company is managed and legally represented by one or more Managing Directors. The Managing Directors are appointed by the company's membership. The management is personally liable for failures of the limited liability company: If they violate their assigned duties, they can be sued and will have to pay damages.

If the company employs more than 500 employees, German law requires the creation of a Supervisory Board. In that case, one-third of the members of the board must be elected by the employees. For all other limited liability companies, the establishment of a Supervisory Board is optional, depending on the choices made in drafting the organisational agreement.

### **Corporation – Aktiengesellschaft (AG)**

A corporation is often the form of choice for organising a business that will raise funds from the general public, e.g. the stock market.

## **3.0 Accounting Procedures**

German accounting distinguishes between

- financial accounting (see below 4.1) and
- tax accounting (see below 4.2).

### **3.1. Financial Accounting**

#### **3.1.1. Overview**

The German financial accounting law applies only to businessmen as defined as in §§ 1 through 7 of the Commercial Code (HGB). A businessman within the meaning of the HGB is someone who runs a business. A business constitutes any commercial operation unless its scope and size do not necessitate a commercial organisation. A person who runs a commercial operation whose scope and size does not necessitate a commercial organisation may voluntarily register his business in the commercial register and become a businessman by virtue of his registration. Freelance professionals are not businessmen. They can not be registered in the commercial register. Corporations and registered partnerships are deemed to be businessmen. The most significant financial accounting provisions, i.e. the provisions for keeping books and records and the preparation, auditing and publication of the annual financial statement are contained within the third book of the HGB (§§ 238 through 342a HGB) with provisions for

- the preparation of the annual financial statement (§§ 238 through 289 HGB)
- the auditing of the annual financial statement (§§ 316 through 324 HGB) as well as
- filing and publication requirements (§§ 325 through 329 HGB)

In addition, special provisions in other Acts are to be observed:

- for stock corporations and partnerships limited by shares: §§ 91 et seq. AktG;
- for limited liability companies: §§ 41 et seq. GmbHG;
- for co-operatives: §§ 33, 53 GenG;
- furthermore, special provisions exist for credit institutions, insurance companies and hospitals.

§ 238 para. 1 HGB requires every businessman to keep books and to show his commercial transactions and his net asset position pursuant to the Generally Accepted German Accounting Principles clearly in them. Furthermore, § 240 para. 1 and 2 HGB and § 242 HGB determine that a businessman must prepare an inventory and an opening balance sheet when establishing the business and an inventory and a financial statement for the close of every financial year thereafter. Generally, this duty embraces the businessman's whole business, i.e. it extends also to his foreign business assets, e.g. business assets located in a foreign permanent establishment.

Non-resident businessmen (sole proprietorships, partnerships and corporations) have to keep books and records and prepare financial statements in Germany pursuant to §§ 238 et seq. HGB to the extent that they maintain a domestic registered branch in the terms of §§ 13d through 13g HGB and if they are classified as businessmen in the terms of § 1 HGB. The classification is made with due regard to the law of the State where the non-resident businessman's effective place of management is located. The books and accounts have to be kept inland for tax purposes pursuant to § 146 para. 2 sentence 1 of the General Tax Code (AO). However, alleviations may be granted by the relevant tax office (§ 148 AO).

The commercial balance sheet together with the profit and loss statement form the annual financial statement for sole proprietorships and registered partnerships (§ 242 para. 3 HGB). In case of corporations and in case of registered partnerships without at least one individual as general partner namely in case of typical GmbH & Co. KGs, the annual financial statement (commercial balance sheet together with profit and loss statement) is extended by notes which together with the commercial balance sheet and the profit and loss statement comprises a whole (§ 264 para. 1 HGB). The annual report supplements the annual financial statement of corporations and of registered partnerships without at least one individual as general partner, except in case of small corporations and partnerships.

### **3.1.2 Generally Accepted German Accounting Principles**

The Generally Accepted German Accounting Principles, most of which are codified, represent a body of rules that help to interpret and to complete the special financial accounting provisions of the HGB. They are to be taken into consideration for the bookkeeping within the financial year (§ 238 para. 1 HGB), for the annual financial statement (§ 243 para. 1 HGB) and also for the preparation of the tax balance sheet (§ 5 para. 1 of the Income Tax Act; see below II. Tax Accounting). They are to be observed, inter alia, in relation to questions concerning the legal requirements for the classification of accounts, valuation and presentation on the balance sheet.

The following fields of application of the General Accepted German Accounting Principles can be distinguished:

- principles of proper bookkeeping (§§ 238, 239 HGB)
- principles of proper inventory taking (§§ 240, 241 HGB) and
- the Generally Accepted German Accounting Principles in a narrow sense.

In practice, the Generally Accepted German Accounting Principles are very important.

## **3.2. Tax Accounting**

### **3.2.1 Overview**

German tax law contains general provisions as regards the keeping of books and records and the preparation of financial statements for tax purposes in §§ 140 through 148 Tax Management Act (AO) supplemented by numerous special tax accounting provisions in the special tax acts.

Pursuant to § 140, taxpayers who are businessmen within the terms of §§ 1 through 7 HGB have to fulfil their obligations to keep books and records and prepare annual financial statements under financial accounting law (see above) also for tax purposes.

Taxpayers who are not businessmen within the terms of §§ 1 through 7 HGB and who operate a trade or business or an agricultural or forestry business have to keep books and records and to prepare annual financial statements for tax purposes in accordance with §§ 238, 240 through 242 para. 1 HGB and §§ 243 through 256 HGB unless otherwise provided for by tax law pursuant to § 141 General Tax Code (AO).

§ 142 Tax Management Act contains supplementing provisions for farmers. §§ 143 and 144 Tax Management Act contain special provisions as regards records relating to receiving and delivery of goods of a trade or business. §§ 145 through 148 contain certain generally applicable accounting principles, e.g. the principle of clarity and lucidity in § 145 para. 1.

The special tax acts like the Income Tax Act (EStG), the Corporate Tax Act (KStG), the Trade Tax Act (GewStG) and the Transformation Tax Act (UmwStG) contain numerous provisions relating to the determination of profit for tax purposes, the most important of which being §§ 4 through 7 EStG. §§ 4 and 5 EStG regulate the basic profit determination methods for tax purposes applicable to individuals and partnerships as well as to corporations.

### **3.2.2. Data Access through Fiscal Authorities (§§ 146, 147, 200 General Tax Code)**

Since 1 January 2002 the fiscal authorities have been authorised to directly access the taxpayers' data within the framework of a government tax audit. Since then, the fiscal authorities have been entitled to inspect stored data and to use the EDP system of the entity concerned for audit purposes. With a decree dated 22 February 2002 I (ref.no. S 0316-6-St421), the Düsseldorf regional finance office has now addressed issues that arise from these new regulations.

The Düsseldorf regional finance office expressly decreed that the introduction of a bookkeeping system or of an archiving system was not to be approved or recognised beforehand by the fiscal authorities. For reasons of neutrality with regard to competition alone, it was impossible to state whether a given system complied with generally accepted

accounting principles. The accounting system had, however, to ensure that stored data was at any time available over the retention period and that it was possible to read and automatically evaluate it immediately. The storage of data permitted the use of vision carriers and other data carriers provided that the respective procedure complied with generally accepted accounting principles. Conventional EDP accounting systems where general ledgers and accounts were printed out or microfilmed continuously or at the year end and the data carriers were deleted thereafter, were no longer compliant with the relevant requirements from 1 January 2002. The acquisition of a special archiving program was, however, not necessary if the accounting program used was provided with sufficient archiving functions or data access could be ensured through other functions. In the future, the stored data had to be kept available if they had been processed with an EDP system. Data processing through the taxpayer by means of an EDP system means that data is input electronically in the data processing system or generated in an EDP system. Beyond these rules, it was crucial for assessing the compliance of an accounting or archiving system whether all vouchers were captured and the persons responsible for voucher archiving could be identified. Vouchers were required to be stored, and the data was required to be reproduced, in an orderly manner and these processes were required to be understandable for a third party. Furthermore, it had to be excluded by the system that, once captured, a voucher was changed. It had to be ensured that the reproduction was always consistent with the original voucher. Digital/ optical archiving was acceptable if all information stated on the original voucher was visually reproduced without deviation from the original copy. Whether the necessary requirements were met, could only be assessed on a case-by-case basis within the scope of a tax audit.

During such an audit, it would also be established whether the archiving system prevented the modification of stored data over the statutory retention period. The system and process documentation had to ensure that an expert third party was able to examine and understand the accounting and archiving procedures within an appropriate period. Original documents were only permitted to be annihilated if the original copy was not required to be retained under other legal provisions, which applied, for example, to opening balance sheets and annual and consolidated accounts.

### **3.2.3 Tax Audits**

Tax audits are carried out in the offices of the taxpayer at regular intervals depending upon the size of the business. The assessments become final and binding once the tax audit has been completed.

### **III. BUSINESS INCENTIVES**

#### **General**

Grants and other kinds of assistance have been available to private industry. In recent years grants have tended to be for regional incentive and job creation.

#### **Most Usual Incentives**

The incentives take the form of cash grants, loan finance (sometimes at preferential interest rates), payroll subsidies, relief from import duty at free-ports, bad debt guarantees for exports, Government guarantees for loans for new small businesses, subsidies for market research and exhibition costs for exports (outside the EU) and tax incentives.

#### **Overview**

- 1) Investment allowance (Investitionszulage)
- 2) Special Accelerated Depreciation Allowance (Sonderabschreibung)
- 3) European Recovery Programmes (ERP) (Marshall Plan funds)
- 4) European Union (EU) Programmes
- 5) Capital Reserves Allowances (Ansparabschreibung)
- 6) The Improvement of Regional Economic Structures Programme (Gemeinschaftsaufgabe or GA funds)
- 7) Grants for research and development, consulting fees and training costs
- 8) Credit programmes
- 9) Deutsche Ausgleichsbank (DtA) (bank for equalisation)
- 10) Kreditanstalt für Wiederaufbau (KfW) (bank for reconstruction)
- 11) European Recovery Programme (EPR) (Marshall Plan)
- 12) European Union (EU) Programmes
- 13) Loan guarantee programmes
- 14) Other major programmes

## **IV. TAXATION**

### **1.0 Individuals**

- 1.1 Rates ➤ 17 % to 47 %
- 1.2 Capital Gains ➤ Taxed at 15 % - 47% Income Tax Rates in case of:
  - Private land or building within 10 years,
  - Shares and stocks are sold within 1 year after buying.➤ There are detailed provisions
- 1.3 Tax Date ➤ 31st May after end of year  
➤ Normally quarterly instalments are payable
- 1.4 Local Property Tax ➤ Is charged on householders and based on reduced property values
- 1.5 Husband and Wife ➤ Special tax table of Euro tax free income (splitting table)

### **2.0 Corporations**

- 2.1 Corporation Tax ➤ Basic 25% on Profits
- 2.2 Local Trade Tax ➤ Based on profit between 14-18%
- 2.3 Capital Gains ➤ 20 % levied on dividends
- 2.4 Tax Date ➤ Due 5 months after end of the calendar year, but companies are required to pay tax in advance quarterly by instalments

### **3.0 Taxation of Trades**

- 3.1 Depreciation ➤ Depreciation rules are moderate  
➤ The tax authority has published a detailed list of depreciation rates
- 3.2 Entertainment ➤ 80% of expenditure allowed as a deduction
- 3.3 Losses ➤ Carry forward: without limit  
➤ Carry back:
  - Companies 1 year
  - Individuals 1 year
- 3.4 Interest Expense ➤ Tax deductible, but thin capitalisation rules apply to foreign companies and, from 1 January 2004, to all companies
- 3.5 Fiscal Consolidation ➤ Each company taxed separately but group relief available for losses, intra group interest, gains, etc.

## **4.0 Tax Changes**

### **4.1 Realisation of Corporate Income Tax Credit**

Through the introduction of the semi-income method and the simultaneous abolition of the previous tax credit system, persons liable to corporate income tax no longer have to classify their distributable equity. The different equity baskets represent an existing corporate income tax credit which can be realised through ordinary profit distributions. The former equity basket 40 (equity taxed at a 40% corporate income tax rate) constitutes a corporate income tax credit of 1/6 of the amount in equity basket 40. All other equity baskets were transferred previously through reclassification to equity basket 40 as at the effective date of 31 December 2000. The realisation of this corporate income tax credit was possible over a period of 15 years according the previous legal position.

### **4.2 Abolition of Multi-parent Group Taxation Relationships**

The multi-parent group taxation relationship is abolished through the Law on Restriction of Tax Relieves. Originally, the controlling company in a tax group could also be a company under the civil code which was established by several partners and held the majority of the voting rights in the shares of the subsidiary. After the amendment of § 14 I 1 No. 2 Corporate Income Tax Law, partnerships with a commercial purpose of business can only be the controlling company if they perform themselves a commercial activity within the meaning of § 15 I No. 1 Income Tax Law. A merely commercial nature of the partnership is no longer sufficient. This is the case if the general partners of the partnership that are authorised to perform management functions are exclusively firms organised in a corporate form.

### **4.3 Changes Concerning Group Taxation Relationships for Income Tax Purposes**

On account of the previous regulation concerning group taxation relationships, a group taxation relationship could be established already for the current year in which the profit transfer agreement was concluded even if the entry in the Commercial Register was effected, and the profit transfer agreement entered, hence, into force, only in the following year. In the future, the income of the controlled company will not be fiscally imputed on the controlling company until the year in which the fiscal year when the profit transfer agreement becomes effective through entry in the Commercial Register ends. Retroactivity is thus abolished. Therefore, the group taxation relationship becomes effective only in the year in which the profit transfer agreement is entered in the Commercial Register. This regulation applies already to the 2002 assessment period provided that the profit transfer agreement was concluded after the cabinet decision on 20 November 2002.



#### **4.4 Group Taxation Relationships and Gross Method (§ 15 Corporate Income Tax Law)**

The amended regulation under § 15 Corporate Income Tax Law will be applicable from the 2003 assessment period. To ensure gross imputation of the controlled company's income on the controlling company, the legislator has made it clear that tax exemptions through the respective double tax treaties become effective only at the level of the controlling company rather than already at the level of the controlled company. This applies also to the tax exemption under § 4 VII Reorganisation Tax Law, which relates to a corresponding gain on take-over upon transfer of net assets to a partnership or to an individual.

#### **4.5 Abolition of Multi-parent Group Taxation Relationships**

In accordance with the changes in the area of corporate income tax, multi-parent group taxation relationships are no longer recognised also for municipal trade tax purposes (§ 2 113 Trade Tax Law).

#### **4.6 Restriction of Loss Deduction for Silent Partnerships**

Through the amendment of § 15 IV 6 Income Tax Law, the legislator restricts the loss deduction for silent partnerships. From the 2003 assessment period onwards, firms organised in a corporate form are permitted to offset their losses from nontypical silent partnerships, from nontypical silent subparticipations or from typical silent partnerships in other firms organised in a corporate form only against profits from the same participation. The losses are offset according to the regulation under § 10 d Income Tax Law (loss carryforward/ carryback).

#### **4.7 Crediting Trade Tax to Income Tax**

Under § 35 Income Tax Law in the version before the Law on Restriction of Tax Reliefs, the income tax is reduced by 1.8 times the tentative tax determined for the enterprise concerned in the assessment period. Such a crediting of trade tax to income tax is now excluded through the legal amendment if the corresponding trade earnings are subject to a low trade tax burden on account of a municipal factor of less than 200%. This new regulation has also been designed to combat trade tax havens and will apply from the 2003 assessment period onwards.

#### **4.8 Crediting Foreign Taxes**

Under § 34 c Income Tax Law, the maximum amounts for crediting foreign taxes are separately computed for every foreign country if foreign-source income is realised in different countries (so-called per country limitation). According to the new regulation, income that is exempt from taxation in establishing the aggregate of the foreign-source income is no longer to be taken into account irrespective of whether they are taxable under German tax law.

In addition, income that the source country would tax under its national law, but is not permitted to tax under a double tax treaty concluded with Germany is also no longer to be included in the aggregate of the income. Furthermore, domestic operating expenses that are economically related to the foreign-source income must always be deducted from the foreign-source income before establishing the maximum amount to be credited irrespective of whether there is an indirect or direct economic relationship.

This amendment was justified by the legislator on the grounds that the previous version of § 34 c Income Tax Law goes far beyond the actual purpose of the regulation, which was to avoid double taxation by crediting foreign taxes. However, there is no double taxation if the income is already tax-exempt or must not be taxed on account of the double tax treaty in the other country. Therefore, such income is excluded from the aggregate of the income that constitutes the assessment basis. By deducting operating expenses that are economically related to foreign-source income, the legislator addresses the federal fiscal court jurisdiction according to which expenses that are economically related to income realised abroad must not be allocated to the income in establishing the foreign-source income of a domestic enterprise. The legislator holds that this legislation leads to an increase in the reference variable »foreign- source income« that is not objectively justified and which is to be addressed through the legal amendment.

#### **4.9 Changes in the Area of the General Tax Code (Transfer Prices)**

Through the Law on Restriction of Tax Relieves, the legislator introduced new documentation duties in the area of transfer prices. The legislator felt compelled to amend the legal regulations because the federal fiscal court had rejected a duty to prepare such documentation on account of the duty to provide assistance concerning underlying facts related to foreign countries under the former version of § 90 II General Tax Code through its ruling dated 17 October 2001. Under § 90 III General Tax Code, taxpayers who maintain foreign business relationships with related persons within the meaning of § 1 II Law on External Tax Relations are now obliged to document these business relationships including the bases of their decision on the establishment of transfer prices and other general terms and conditions. Related persons within the meaning of § 1 II Law on External Tax Relations are regularly those who hold a material share in each other or exert a controlling influence on the other person. These business relationships must stand the internationally accepted arm's-length test, which means that transactions among related persons must be subject to conditions that would have been agreed among independent persons dealing at arm's length. The legal obligations to keep books and records within a group cover also the apportionment of profits between company headquarters and permanent establishment. The fiscal authorities must generally not request the submission of documentation other than for the purposes of a tax audit. Moreover, a timely documentation of accountable events is likely to be requested only for extraordinary business transactions (e. g. intra-group restructuring). The time for submitting the documentation is generally, however, 60 days. An extension of this time is possible in justified exceptional cases. If usable records fail to be submitted on time, a surcharge of up to Euro 1.000,000 can be imposed. This surcharge amounts to at least Euro 100 for each day of the time delay until submission.

If no records are submitted or the records submitted are not usable, the surcharge to be imposed is 5 to 10% of the additional amount of the income, but not less than Euro 5,000. Regulations providing detailed guidance on the new legal obligations to keep books and records remain to be prepared. This will be necessary because non-compliance with the duties to keep books and records authorises the fiscal authorities to estimate the income.

The legal obligations to keep books and records according to § 90 III General Tax Code have to be fulfilled for the first time for business years beginning after 31 December 2002. Obligations to keep timely records concerning permanent debt relationships that are deemed to be extraordinary business transactions within the meaning of § 90 III General Tax Code, that were established before the beginning of the above-mentioned business year and that

still exist must be fulfilled within 6 months after the regulations that remain to be adopted entered into force.

## **5.0 Other Significant Taxes**

Germany's value added tax regime is basically identical to that of the other EU member states. The standard rate is 16 percent (7 percent for specified supplies), and in principle both the supply of goods and the rendering of services are considered taxable transactions if performed by an entrepreneur. Specific rules apply to the delivery of goods within the EU.

One of the most important features of the VAT system is the entitlement of the entrepreneur to a deduction for any input VAT incurred on supplies of goods or services by other entrepreneurs. Restrictions apply but in most cases VAT should eventually not turn into an additional cost to the entrepreneur. Other German taxes that a foreign investor should be alerted to include a relatively moderate real property tax to be remitted annually by landowners and a 3.5 percent real property transfer tax which is imposed on the transfer of land and the assignment, directly or indirectly, of at least 95 percent of the shares in a company that owns German real property. Taxes payable are determined on the basis of a specific value which is usually around 25% to 40% below the actual fair market value. Real property transfer tax issues often tend to be complex, and in many cases they constitute a real obstacle to internal corporate reorganisations.

## **V. LABOUR**

### **1.0 Population**

The total working population of Germany is approximately 38 million. Overall unemployment has been split between West Germany (approx. 6-7%) and East Germany (approx. 10-20%): There is an employment gap between the Eastern and the Western part of Germany.

### **2.0 Work Force and Employment Law**

#### **2.1 Immigration Regulations**

Foreign nationals generally need to obtain a visa or residence permit (Aufenthaltsgenehmigung) in order to live and work in Germany. With the exception of citizens of European Union countries, foreign nationals must also generally obtain an employment permit (Arbeitserlaubnis) in order to work in Germany. A special "green card" program facilitates and speeds up the work of foreigners in Germany who are highly qualified. Otherwise authorisation is only issued in exceptional cases, e.g. mainly for employment related to continuing professional development, work as a leading executive or manager (with a power-of-attorney for the business), or within the framework of company cooperation or employment where an international ex-change is generally established. If the employer can demonstrate a "public interest" in the employment, then authorisation can also be granted.

#### **2.2. Employment Agreement (Arbeitsvertrag)**

It is law to have a written employment agreement. The rights and duties of employees are defined by the terms and conditions of the employment agreement, respective applicable labour laws and collective bargaining agreements.

On the other hand, an employer is obliged to properly compensate the employee for his or her performance and to pay social security and taxes. An employment agreement can never place an employee in a worse position than the minimum standards under labour laws.

Termination of an employee is possible under German labour laws, although compensation packages are comparatively low. Specific risks U.S. employers are exposed to, such as costly libel or sexual harassment suits, are not as prevalent in Germany; awards for damage compensation granted by German courts are significantly lower than in the United States.

### **2.3 Social Security System (Sozialversicherung)**

Foreign nationals and Germans are treated equally under the German social security system. The employer must insure the employee against illness and unemployment. It must also bring the employee into the state required pension system.

The employee applies for a social security identification card (Sozialversicherungsausweis) while the employer obtains an income tax payment card. Employers must belong to the legal pension and unemployment insurance funds. They can also provide supplemental private retirement benefits. Employees cannot opt out of German public health insurance unless income exceeds a certain level. Health insurance premiums are split 50:50 between employer and employee.

### **2.4 Collective Bargaining Agreements ( Tarifverträge)**

Collective bargaining agreements play an important role in German employment relationships. These agreements are usually negotiated between employee and employer unions/ associations in the various business sectors. The resulting agreement is valid for that entire business sector and is deemed to form a part of all employment agreements in that sector. These settlements apply equally to employees and employers; they focus on minimum wages and employee salaries.

### **2.5 Freelancer**

Independent workers exist in most industries. They make contributions to social security. For these reasons the criteria for establishing independent working are becoming more onerous and are carefully monitored by the Department of Social Security and the Tax office.

Firms with a lot of freelancers will be audited regularly by the tax office and Department of Social Security. Freelancers should have a letter from the Tax office that they are reasonably registered.

Non-resident entertainers and sportsmen are required to have tax deducted, generally at the basic rate, from all payments made in respect of activities in Germany.

### **3.0 Employment Conditions, e.g.**

- a)** Wage earners are paid monthly by bank transfer. Office workers normally work 36-40 hours per week normal time and manual workers approximately 36-40 hours per week. This depends on the collective bargaining agreement.
- b)** Holidays vary but would tend to be a minimum of three weeks and a maximum of six weeks. More general agreements would currently cover four or five weeks. There are in addition statutory holidays, of which there are 24 days (Mo-Sa) in a year.
- c)** Workers are subject to the regulations laid down by individual companies. All who have been employed have rights under Employment Legislation and are entitled to compensation. All employees are entitled to written contracts of employment giving details of pay and job specification, entitlements to sick pay, pension arrangements and other benefits.

- d)** Businesses must comply with statutory minimum wage levels.
- e)** All foreigners other than EC nationals require work permits to take up employment in Germany. Permits are granted by the Department of Employment but tend only to be issued if the employer cannot obtain a resident to fill a vacancy. An employed foreigner who wishes to reside for more than 6 months in Germany also requires a residence permit from the Immigration Department of the Home Office.
- f)** There are many Social Security benefits including retirement pensions, statutory maternity pay, statutory sick pay, unemployment benefit, additional benefits for the aged and infirm, and child tax credits. Contributions to the State insurance fund are made by both employee and employer.

## **VI BANKING, FINANCE AND CUSTOMS DUTIES**

### **1.0 Banks and other Financial Institutions**

#### **1.1 Deutsche Bundesbank and the European Central Bank**

Frankfurt is one of the major financial centres in Germany.

The Deutsche Bundesbank, based in Frankfurt, is Germany's central bank. The bank is the banker to the Government, to foreign Central Banks and to German commercial banks. It issues Euro notes and regulates banking and other deposit taking business. The influence of the European Central Bank will raise steadily.

The Bundesbank long regulated the money supply in Germany and handled the settlement of international payments. It monitored the value of the deutsche mark, focusing on its domestic purchasing power and its relationship to stable foreign currencies.

The Bundesbank's most important characteristic has been its independence from the government. The Bundesbank is made up of regional central banks (Landeszentralbanken), representing the federal states (Länder). In the gradual process of establishing European Monetary Union (EMU), the European Central Bank in Frankfurt assumed the Bundesbank's responsibilities regarding monetary and currency policy on Jan.1, 1999. The Bundesbank thereby became an integral part of the European system of central banks.

#### **1.2 The German Banking System**

The major commercial banks are the six clearing banks as follows:

##### **Banks**

- Deutsche Bank AG, Frankfurt
- Dresdner Bank AG/ Allianz Insurance Group, Frankfurt/ München
- Hypo Vereinsbank, München
- Commerzbank
- Savings banks (Sparkassen)
- Co-operative banks (Genossenschaftsbanken)

The most important difference between German and Anglo-Saxon banks is also structural: German banks are universal, not specialised. There is no separation of investment and commercial banking or of conventional and real estate loans, no Glass-Steagall Act or other restrictions.

The admirable stability of the country's banks derives from the diversity of their activities. Private savings accounts and loans, real estate financing, corporate credits and project financing, export credits and public sector lending, asset management, trading in shares, foreign exchange and derivatives: the list of business activities is massive.

Germany's four big banks are less important than they seem at first sight. Savings banks (Sparkassen) are the heart of the financial community. The overall market share of the 700

saving banks, often called 'local universal banks', together with the clearing banks, amounts to 40%. These banks are particularly strong in the conventional retail banking business.

There is a large and growing number of foreign banks with branches in Frankfurt (approximately 300) dealing with foreign exchange and occasionally offering retail banking services.

### **1.3 The Frankfurt Stock Exchange**

The Frankfurt Stock Exchange (Frankfurter Wertpapierbörse, FWB) is the world's third-largest stock exchange. Its annual turnover of more than € 4 trillion and its 80 % share of total German stock market turnover makes it the largest of the eight German stock exchanges. The Frankfurt bourse is operated by Deutsche Börse AG, which ensures the proper functioning of securities transactions. The international character of the Frankfurt

Stock Exchange is mirrored by its membership. Its 330 members include more than 70 foreign banks and financial services firms.

### **1.4 Organization of the German Stock Exchange**

In contrast to the centralized structures in most other countries, the German stock exchange system has a federal structure. It consists of regional exchanges or trading centres, where different bourse segments deal in fungible securities.

Germany's regional exchanges in Düsseldorf, Munich, Hamburg, Stuttgart, Berlin, Bremen and Hanover are considerably smaller than the Frankfurt Stock Exchange, Germany's major exchange. Among other things the smaller exchanges concentrate on regional new issue markets and theme market, while also partly focusing on trading in specialized products.

The Securities Exchange Act (Börsengesetz, BörsG) provides the broad framework for the constitution and structure of the German securities market. Details are delegated to the autonomous administrative bodies of the local exchanges.

The German Federal Securities Supervisory Authority (Bundesaufsichtsamt für den Wertpapierhandel, BAWe), founded in 1995, is instrumental in monitoring stock exchange transactions. The supervisory authority enforces the regulations of the Securities Exchange Law (Wertpapierhandelsgesetz, WpHG). Among its key tasks are:

- Inspecting securities traders such as banks and savings banks (Sparkassen) and their services;
- detecting and prosecuting prohibited insider transactions;
- examining whether businesses fulfil their publicity obligations, such as ad hoc publicity and the declaration of changes in voting rights; and
- international cooperation with other stock market supervisory authorities.

Aside from the federal securities supervisor, state stock market supervisory authorities exercise direct control over trading on the individual exchanges located in their state.



### **1.5 The Hausbank System**

Standard practice under the Hausbank system dictates that a company will typically choose one bank to handle all its business, allowing a long-term relationship to grow up between bank and company. Some recent corporate collapse have revealed that even very large companies with an enormous annual turnover still rely on one major lender. From the company's point of view, this loyalty is perhaps the positive aspect of the Hausbank system. A German bank tends to show more patience to a corporate client that finds itself in financial difficulties if it understands that company and has lent to that company over a number of years. Another difficult aspect of the Hausbank tradition from the client's point of view is the time it takes to build up a worthwhile Hausbank relationship.

In the past, a fledgling entrepreneur had almost no hope of getting a loan from bankers unless he had a track record of at least three years. Bankers were less interested in the entrepreneur's business acumen and management skills than the astuteness of the products and services offered.

That attitude is gradually changing. A survey of 88 German banks carried out in 1995 found that the increasing instability of the markets and shorter product lifetimes were causing German banks to rely less on traditional balance-sheet analysis and collateral checks. Instead, lenders are now guided by indications of management quality, EDP systems and technological standards.

On balance, companies remain well advised to maintain a Hausbank relationship with one institution, even though they may have accounts at several other banks for cash management purposes.

### **2.0 Exchange Control**

There is no exchange control in Germany and no consent is required for investment in Germany or for investment by German bodies outside Germany. Nor is any consent required for borrowing outside the country. But there are provisions to fulfil.

### **3.0 Customs Duties**

No customs duties VAT or excise duty needs to be paid on cross border transactions between a German trader and a registered trader in the EU but duties are levied on other imported goods on the terms of the common customs tariff of the EU. A trader can defer the duty and VAT on import and can arrange for a single total sum to be paid monthly. This deferral facilitates easy entry of goods at the point of entry to Germany. But there are many law provisions to respect.

## VII MISCELLANEOUS REGULATIONS

1. There are a number of important regulations e.g.
  - 1.) **Act on Taxation of Foreign Commercial Relations (Foreign Tax Act, 2000)**
  - 2.) **Circular Regarding the Application of the Foreign Tax Act**
  - 3.) **Transfer Pricing Circular**
  - 4.) **Cost Contribution Arrangements Circular**
  - 5.) **Permanent Establishments Circular**
  - 6.) **EU Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises**
  - 7.) **Thin Capitalisation Circular**
  - 8.) **Corporate Tax Loss Carry Over Circular**
  - 9.) **Atypical Silent Partnership Circular**
  - 10.) **Circular Regarding the Application of § 8b para. 7 KStG**
  - 11.) **Treasury Shares Circular**
  - 12.) **Film and TV Funds Circular**
  - 13.) **Intellectual Property Protection, Licensing, Basic Unfair Competition Law and Comparative Advertising:** On Jan 1, 1995 a new trademark law came into force in Germany, implementing EC Directive 1989/104 on the harmonisation of the Trademark Law of EU Member States.
  - 14.) **Patent Protection Including EPC and PCT Registration**  
Patent applications in Germany are governed by the Patent Act of 1980 as amended in 1994.
  - 15.) **European Patent Applications and Patents (EPC) and International Patent Applications (PCT):** The European Patent Convention (EPC) has been applicable in Germany since Oct. 7, 1977. The international Patent Co-operation Treaty (PCT) was signed by Germany and came into effect on Jan. 24, 1978.
  - 16.) **Other Industrial Property Rights:** Other industrial property rights that can be exclusively protected by registration are utility models, industrial design, semiconductor chips and plant varieties.
  - 17.) **German Copyright Law:** German copyright law is regulated by the German Copyright Act of 1965 (Urheberrechtsgesetz) as amended in 1972, 1985, 1990 and (implementing provisions of the EC Directives) 1996.
  - 18.) **German Competition Laws:** German merger control –antitrust law- is based on the Act Against Restraints of Competition (Gesetz gegen Wettbewerbsbeschränkungen) in its revised version of Jan. 1, 1999. This law is extremely detailed and highly restrictive.

## VIII CHECK LIST

1. You will need a good commercial solicitor, notary or banker.  
Your Alliot Group associate has these contacts.
2. Are you buying into Germany? If so, into a limited company or a AG? If a AG, be aware of the additional legal requirements.
3. If you are setting up and have been selling through an agent into the Germany previously, has he a contract which you will breach?
4. You will need premises. Where should they be?
  - Frankfurt may be considered essential.
  - Consider communications. The Germany has very good motorways and rail systems.
  - Grants or loan finance are available in development and intermediate areas e.g. in East Germany.
  - To buy or not to buy, that is the question. Who buys? You? Your Parent Company? Your Subsidiary?
5. Branch or subsidiary?
  - Local representative or directors?
  - Double Taxation Convention with Germany?
  - Do you expect to make losses initially?
  - Plan for the most tax efficient repatriation of profits.
  - Does the Convention provide for the imputation system of Corporation Tax?
  - If a branch, are you sufficiently recognised to give confidence to German suppliers?
  - How will you finance the venture? Share capital or share capital and loan capital or long trade credit?
  - Are you prepared to file in Germany the accounts of the parent?
  - Will you be allowed to use your name in Germany?
6. Memorandum & Articles of Association of your subsidiary. Get them correct at commencement.
7. Will you give an equity holding to key employees and what happens if they leave?
8. Are you seconding any of your local employees? If so, who should pay them and will they require work permits?
9. Are your products liable to duty on import to Germany? Remember the Customs guarantee system.

10. Are you going to export from Germany? Do you require Export Credits Guarantee Department cover?
11. Will your employees be Union members and will you have to consult them or with the Unions themselves?
12. Consider pension arrangements and share option schemes for your employees.
13. Insurance cover is always advisable and some is legally required.
14. If you require finance from a German bank, do not approach the banker without having prepared a good business plan.
15. Do you have trade marks, patents or other intellectual property that you would want protected?