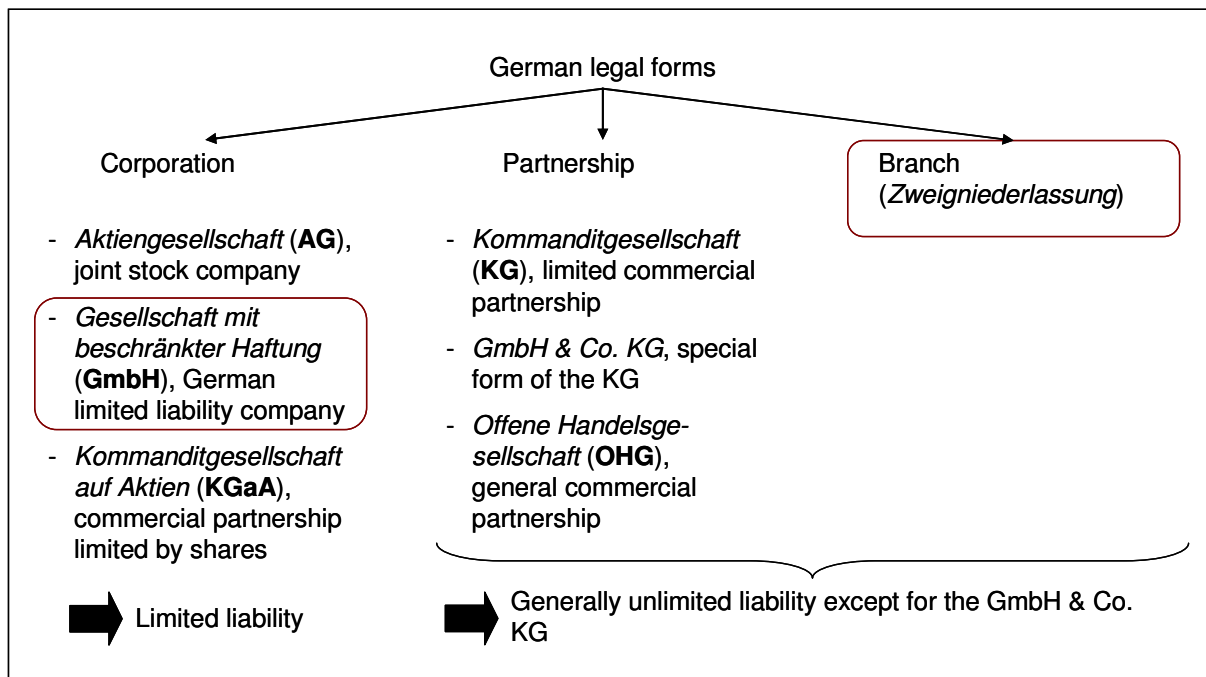


## Doing Business in Germany

Germany is one of the world's most experienced market economies and the world's fourth biggest economy. Large markets, the central location in Europe, basically no restrictions for entrepreneurial investments, qualified personnel, a high level of innovation, a highly developed infrastructure, its legal system and much more qualifies Germany as a favoured place for conducting business. If therefore a foreign company is planning to expand its business to Germany, the company has always to deal with the main question which is the best legal form to do long-term business operations in Germany and to meet its individual business strategy.

In Germany there are many different legal forms which can differ from each other in terms of requirements of incorporation, liability, management, financing matters and of their taxation. Here you can see an overview of the domestic legal forms:



Experience shows that most foreign companies set up a branch (*Zweigniederlassung*) (hereinafter “**Branch**”) or a German limited liability company (*GmbH*), (hereinafter “**GmbH**”), when starting business in Germany. The opportunities given by these two forms are very different and have to be weighed up against each other in relation to the foreign company’s business plan.

In the following a presentation as well as a brief comparison of the two legal forms GmbH and Branch as well as additional information on a representative office should give you a first idea about these forms and their specific opportunities. Please contact us for a detailed analysis in your individual case.

## 1. Incorporation of a GmbH

### 1.1 Company law aspects of a GmbH

As a legal entity, the GmbH is separated from its shareholders and is able to conclude contracts or accomplish other legal acts. The GmbH can be formed for any purpose permitted by law and is typically used by small and medium-sized businesses, whereas there are big businesses in the legal form of a GmbH, as well.

Furthermore the GmbH is required to have a minimum share capital of 25.000 €.<sup>1</sup> At the date of incorporation at least 25 % of each shareholding and in total at least 12.500 € have to be paid up. In addition a registration in the German Commercial Register is necessary.

The entrepreneur company (*Unternehmergeellschaft*, hereinafter “UG”) or the so-called “Mini-GmbH” is regarded as a special type of the GmbH. In principle, all provisions which refer to the GmbH also refer to the UG except for the capitalisation. The minimum share capital of an UG is 1 €, but at the date of incorporation the entire amount of the registered share capital has to be paid up and the shareholders have to set up a reserve equal to a quarter of the annual surplus minus an accumulated deficit of the preceding year. The restriction for the reserve no longer applies when a share capital of 25.000 € is reached.

A GmbH is founded by one or more shareholders who can be natural or legal persons regardless of their nationality. The shareholders’ liability is limited to the amount of their subscribed share capital. Beyond that only the company itself is liable with its assets.

The management of a GmbH is executed by one or more managing directors who are not necessarily shareholders of the GmbH.

Another body of a GmbH is the supervisory board, the main function of which is monitoring the managing directors. This board is optional or, if the GmbH has 500 or more employees, mandatory. If there are 500 or more employees, 1/3 of the board must be employee representatives. If however, there are 2.000 or more employees, 1/2 of the board must be employee representatives.

There are also some reporting provisions for the GmbH. Therefore the annual financial statements (balance sheet, profit and loss statement, notes) and, if necessary, the management report and an audit certificate have to be reported in the German Federal Gazette (*Bundesanzeiger*). However, small-sized companies are only required to report the balance sheet and the notes because an audit is not mandatory in their case.

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<sup>1</sup> In comparison, a German joint stock company (AG) must have a minimum share capital of 50.000 €.

## 1.2 Taxation facts

### Specific taxes, tax rate, tax base

If a GmbH is considered as a corporation which is tax resident in Germany (the company's seat and/or place of management are situated in Germany), the GmbH's worldwide income is subject to corporate taxation (unlimited tax liability). In principle, the following taxes are levied:

Corporate income tax (CIT):	15,0 %
Solidarity surcharge (SSC):	
5,5 % on CIT =	0,8 %
<u>Trade tax (TT; assumed local multiplier = 400 %):</u>	<u>14,0 %</u>
→ Total tax rate (approximately)	30,0 %

The basis for determining the taxable corporate income is the income shown in the commercial profit and loss statement to which certain adjustments will be made. Foreign corporate income tax on the GmbH's income received from outside of Germany can be (partially) deducted from the amount of German corporate income tax (credit method - *Anrechnungsmethode*), or from the corporate income tax base (deduction method - *Abzugsmethode*). In case of the credit method the deductible amount of foreign corporate income tax is limited to the corresponding amount of German corporate income tax whereas the deduction method does not include a limitation. Generally, the credit method is the more favorable option. But if the amount of foreign corporate income tax is significantly higher than the triggered German corporate income tax or if the foreign corporate income tax cannot be credited because a German corporate income tax is not levied, preference should be given to the deduction method.

German trade tax is a municipal tax. Its rate depends on the location of the business as the local multiplier which determines the effective trade tax rate is fixed by the municipality.<sup>2</sup> The tax base is the corporate income adjusted by some add-backs (e.g. a 25 % add-back of interest payments on debt) and deductions (e.g. profits from domestic and foreign subsidiaries under certain conditions). The effective trade tax rate is calculated as follows:

$$\text{tax rate} = 3,5 \% * \text{local multiplier set by the municipality}$$

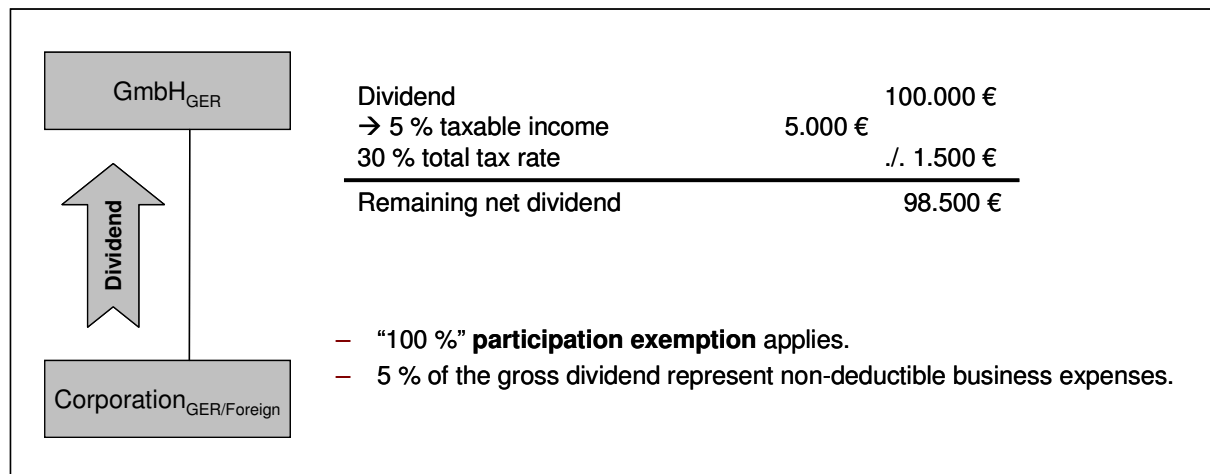
The local multiplier has to be at least 200 % to the effect that the minimal effective trade tax rate amounts to 7 %. A maximum is not fixed for the multiplier (e.g. Munich's local multiplier is 490 %; accordingly, the effective trade tax rate is 17,2 %).

<sup>2</sup> Since the beginning of the year 2008, trade tax is not any longer a deductible business expense from the taxable corporate income.

If an enterprise operates in several municipalities, the amount of trade tax is allocated to each municipality according to the wage bill in the respective municipality in relation to the total wage bill of the enterprise.

Taxation of dividends

If the shareholding of a corporation is at least 10 %, dividends received from German or foreign subsidiaries are tax exempted. But effectively only 95 % of the dividends are exempted as 5 % represent non-deductible business expenses irrespective of the actual expenses the company incurred.



Tax loss carry-forwards and carry-backs

For corporate income tax purposes, there exists an optional tax loss carryback for one year up to a maximum amount of 511.500 € (1.000.000 € starting with assessment year 2013). A tax loss carry-forward is possible without time limit, but it is subject to minimum taxation: Taxable income exceeding 1 million € may only be reduced up to 60 % by loss carry-forwards. 40 % of taxable income exceeding 1 million € cannot be reduced by loss carry-forwards and triggers corporate income tax.

For trade tax purposes, there is no tax loss carry-back applicable. The rules for tax loss carry-forwards are the same as for corporate income tax purposes.

Filing of tax returns

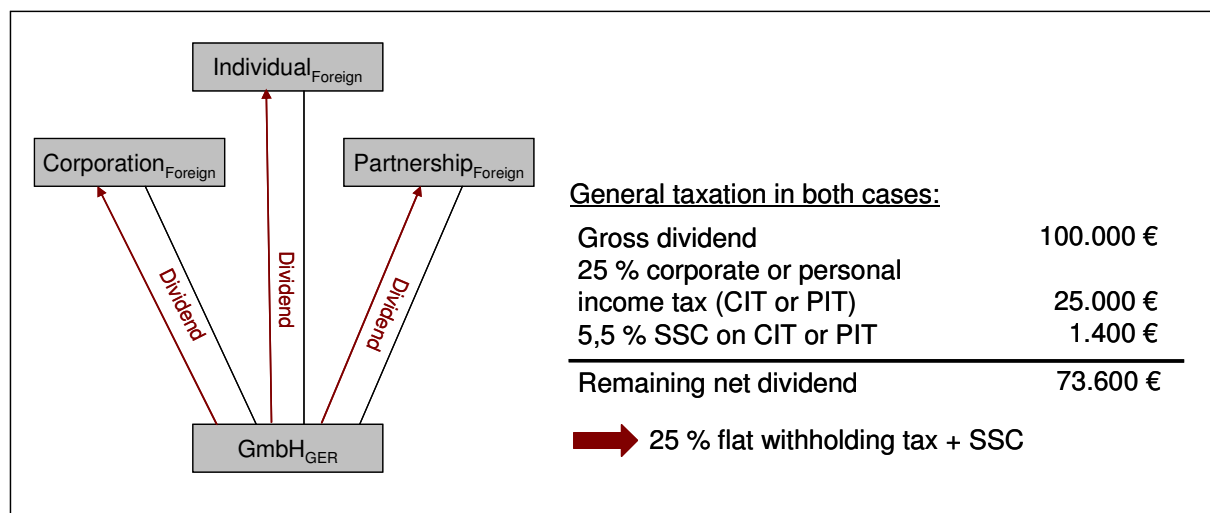
Corporate income and trade tax returns must be filed annually. For tax returns prepared by tax advisors, the filing deadline is December 31st of the year following the year of the business year end, for example for business year January 1st 2011 to December 31st 2011 the tax returns have to be filed latest by December 31st 2012.

The advance VAT returns must be filed until the 10th day after the expiration of the advance tax return period. In most cases, the advance tax return period is one month.<sup>3</sup> In addition, VAT returns must be filed annually. In the case of intra-community deliveries and of other services executed in other EU member states, an aggregate sales listing must be presented.

Taxation on the shareholder's level

The income of the non-resident shareholder, which consists in many cases in dividend, interest or royalty income is in principle subject to German withholding tax as this income is sourced in Germany (limited tax liability).

Regardless of whether the foreign shareholder of the GmbH is a corporation, a partnership or an individual, the dividend income is generally subject to a 25 % corporate or personal income tax and 5,5 % solidarity surcharge thereon.



However there are exemptions from this rule if a special national tax rule, the Parent-Subsidiary Directive or a double tax treaty (hereinafter “DTT”) is applicable.

According to a special national tax rule the corporate income tax rate on dividend income of a foreign corporation may amount to 15 %, if the corporation is considered as a “substantial” enterprise which does not generate only “passive” income. The fiscal procedure in this case is as follows: Firstly, the enterprise has to pay 25 % corporate income tax and solidarity surcharge thereon, then, 10 % corporate income tax plus solidarity surcharge will be refunded on request.

According to the Parent-Subsidiary Directive – transposed into German tax law – a 100 % tax exemption for a dividend paid by a German resident corporation is provided if a EU resident corporation owns at least 10 % of the subsidiary for more than one year. In this case the

<sup>3</sup> The period is one month, if the amount of tax paid in the past is higher than 7.500 € per year or if it is a start-up business. Otherwise the period is three months.

corporation may apply for exemption in advance with the effect that the corporate income tax must not be withheld.

Furthermore the withholding tax on dividend income might be reduced or exempted by a DTT. In the case of a corporation, corporate income tax is usually exempted or reduced if a minimum share quote is held (in general a quote of 10 % or 15 %). In many other cases corporate or private income tax is reduced in general down to at least 15 %.

Any request for refund of withholding tax or for tax exemption in advance has to be filed to the German Federal Central Tax Office (*Bundeszentralamt für Steuern*).

Under the terms of the national tax law there is generally no withholding tax on interest income within the scope of limited tax liability. But in certain cases a withholding tax of 25 % is levied. For example, if the capital assets are secured by German real estate and if the interests are paid by a German credit or financial services institution. According to the majority of DTT withholding tax on interest income is usually reduced to 10 % or less.

The withholding tax on royalties is generally 15 %. But some DTT commonly provide an exemption of withholding tax and other DTT reduce the withholding tax to less than 15 %.

#### Transfer pricing

Transfer prices for transactions between the German corporation and its parent company must be determined on an arm's length basis to be accepted for tax purposes. Detailed German rules on determining transfer prices are completely applied. Depending on the amount of transactions between the entities within a group, a detailed transfer pricing documentation must be prepared.

#### Tax planning opportunities

Assuming that a foreign company wants to incorporate more than one company in Germany, the implementation of a so-called "integrated fiscal unit" (*Organschaft*) enables the consolidation of the German companies' profits and losses for corporate income and trade tax purposes. In the structure of integrated fiscal units only corporations (e.g. a GmbH) can be controlled companies, the controlling company can be a corporation or other enterprises (e.g. commercial partnerships).

## 2. Setting up a Branch

### 2.1 Characteristics of a Branch

An autonomous Branch is not a legal entity, but an economically independent entity of the foreign company (the head office). This means that the Branch and the head office are part of one company which implies further that:

- Although the Branch has its own business place, own management and own bank account, it is still involved in the business activities of the head office and can only make contracts or accomplish other legal acts in the name of the head office.
- Contrary to the GmbH the Branch cannot get loans from the head office since the Branch cannot conclude loan agreements with the head office; the branch has no legal personality.
- The profits of the Branch are considered as profits of the head office sourced in Germany.
- The head office is liable for the obligations of the Branch.
- Solely the head office can sue and be sued in matters regarding the Branch.

In general a Branch can be set up easily by a domestic or a foreign company. There are no capital requirements. But it is required that the Branch is entered in the commercial register of the local court in the district where the Branch is located. In the application form for the commercial register special contents are mandatory. The main contents are as follows:

- Certificate of registration of the head office from the Commercial Register of its home country
- Business permits if the business purpose requires a state approval in Germany
- The address and purpose of the Branch
- The legal form as well as the country of the registered seat of the head office
- The persons authorised as permanent representatives for the activities of the Branch (Branch manager) as well as a description of their authority<sup>4</sup>
- An officially certified copy of the articles of the head office

**Note:** After the Branch's registration in the Commercial Register, any modifications concerning the contents of the application form must be filed with the Commercial Register of the Branch.

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<sup>4</sup> To be authorized as a permanent representative, the Branch manager must have a procurator or power of attorney.

### Administrative and reporting provisions

A German Branch is subject to German bookkeeping requirements for commercial and tax purposes. It must prepare its own balance sheet and profit and loss statement. The annual financial statements of the head office must be published in Germany but not of the Branch.

## **2.2 Taxation facts**

### Specific taxes, tax rate, tax base

Autonomous Branches represent from a tax point of view “permanent establishments” (*Betriebsstätte*) of non-resident companies. By implementing a Branch in Germany a foreign company (head office) generates German sourced corporate profits which are subject to corporate or private income tax (limited tax liability), solidarity surcharge thereon and trade tax.<sup>5</sup> The basis for determining the taxable income is the income shown in the Branch’s commercial profit and loss statement to which certain adjustments will be made.

Depending on the legal form of the head office, corporate or private income tax is applicable. If the head office is a corporation or a commercial partnership with corporations as partners, corporate tax at a rate of 15 % is levied. If the head office is a commercial partnership with individuals as partners, private income tax is levied on the amount of taxable income.

Mainly if an individual is the Branch’s owner, the income liable to trade tax is reduced by a tax allowance of 24.500 € whereas in case of a corporation there is no tax allowance. Furthermore, trade tax can be deducted from private income tax. Therefore, 3,8 times of the trade tax assessment base (*Steuermessbetrag*) can be deducted from the amount of private income tax.<sup>6</sup>

### Application of a DTT

The profits generated by the Branch in Germany are generally taxed in the head office’s state of residency, too. This double taxation is normally reduced by a DTT in the way that German corporate or private income tax can be credited against income tax under the condition that the creditable German income tax cannot exceed the foreign income tax.

### Tax loss compensation, tax loss carry-forwards and carry-backs

Losses of a German Branch can be offset against other German sourced income of the head office (tax loss compensation).<sup>7</sup> Concerning tax loss carry-forwards and carry-backs, the same rules as for the GmbH described in Chapter 1.2 apply.

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<sup>5</sup> See chapter 1.2 for information on how to determine the trade tax and the rates of corporate income tax and trade tax.

<sup>6</sup> Determination of trade tax assessment base (*Steuermessbetrag*) in the case of private income liable persons: (trade tax liable income – tax allowance) \* 3,5 %.

<sup>7</sup> Principally tax loss compensation affects all German sourced income of the foreign company except such income on which withholding tax is imposed.



### Filing provisions for tax returns

Please, refer to the statements concerning the GmbH in Chapter 1.2 which also apply for the Branch.

### Transfer pricing

Transactions between a Branch and its head office are legally non-existent because the Branch and the head office are part of the same legal entity. But in order to determine the Branch's taxable income it is hypothesised that transactions are realized between two separate legal entities.

Therefore, to be able to determine the taxable income the result of the whole entity (Branch and head office) has to be split up based on an analysis identifying functions, risks and ownership or use of assets and transactions between Branch and head office. The transfer price for transactions between a Branch and its head office must be determined on an arm's length basis to be accepted for tax purposes.

## **3. Setting up a “representative office”**

The main purpose of a so called “representative office” is the initiation of business transactions and to maintain business contacts, but no independent commercial transactions (especially no signing of any contracts in the name of the company).<sup>8</sup> A representative office is like a dependent branch (opposite of the independent branch under chapter 2). It can be established easily by setting up a fixed office with one or more employees. A registration in the commercial register is not necessary. The only formal requirement is the registration in the local trade office (“Gewerbeanmeldung”). Therefore, the trade office needs the following documents and information:

- A Certificate of Registration of the head office from the commercial register of its home country
- Business permits, if the business requires a state approval in Germany
- The address and purpose of the “representative office”
- The legal form as well as the country of the registered seat of the head office

From a tax point of view, a “representative office” represents a “permanent establishment” (*Betriebstätte*) of a non-resident company. According to the most double tax treaties with Germany, profits sourced by a representative office are generally not liable to German income taxes because the activity of this office can be qualified as an auxiliary activity as defined in Art. 5 paragraph 4 OECD Model Tax Convention.

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<sup>8</sup> Especially for tax purposes it is advisable to agree in writing with the employees that they are not authorized to sign contracts in the name of the head office.

#### 4. Synopsis

	GmbH	Branch
<b>Company law aspects</b>		
<b>Legal form</b>	Corporation, legal entity	No legal entity, but an economically independent Branch of the foreign company (the head office)
<b>Capital</b>	- minimum share capital: 25.000 €  <u>Special type:</u> entrepreneur company - minimum share capital: 1 €	- no capital requirements → „inexpensive“ formation
<b>Founders</b>	One ore more shareholders	Head office or company's head-quarter
<b>Liability</b>	Limited liability of the shareholders	Full liability of the head office
<b>Management</b>	One or more managing directors who are not necessarily shareholders	One or more Branch managers
<b>Supervisory board</b>	Optional or mandatory	No board
<b>Reporting requirements</b>	Report of the annual financial statement, the management report and possibly of an audit certificate	Report of the annual financial statements of the head office

	GmbH	Branch
<b>Taxation facts</b>		
<b>Specific taxes tax rates tax base</b>	<ul style="list-style-type: none"> <li>- Corporate income tax (CIT): 15 %</li> <li>- In the case of a Branch also possible: private income tax (PIT): tax rate depends on the amount of taxable income</li> <li>- Solidarity surcharge (SSC) 5,5 % on CIT or PIT</li> <li>- Trade tax (TT; assumed local multiplier = 400 %): 14 %</li> </ul> <p>Tax base is the income shown in the commercial profit and loss statement to which certain adjustments have to be made.</p>	
<b>Withholding tax</b>	<ul style="list-style-type: none"> <li>- Generally 25 % CIT or PIT and 5,5 % SSC on CIT or PIT</li> </ul> <p>Exceptions:</p> <ul style="list-style-type: none"> <li>- 15 % CIT for “substantial” foreign corporation</li> <li>- 0 % CIT under application of the Parent-Subsidiary-Directive</li> <li>- Tax exemption or reduction because of a DTT</li> </ul>	No withholding tax
<b>Transfer pricing</b>	<ul style="list-style-type: none"> <li>- Detailed rules on determining transfer prices and documentation</li> <li>- Tax adjustments if the dealing-at-arms’ length’s principle is not fulfilled</li> </ul>	
<b>Consideration of tax loss</b>	Tax loss compensation for nearly all German sourced income of the Branch owner	
	- Loss carryback for one year: max. 1.000.000 €	
	- Loss carryforward without time limit, but minimum taxation	
<b>Filing of tax returns</b>	- Annual corporate income tax return	- Annual corporate or private income tax return
	<ul style="list-style-type: none"> <li>- Annual trade tax return</li> <li>- Advance VAT return per month or every three months and annual VAT return</li> </ul>	
<b>Tax planning opportunities</b>	Implementation of “integrated fiscal units”	No essential tax planning opportunities