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Featured Perspectives

Life Goes On: The Second Life of the German Trade Tax

by Wolfgang Kessler and Rolf Eicke

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"Old taxes are good taxes" might have been the conviction of the German lawmakers that supported the German trade tax. The survival of this tax was anything but certain, because in late 2005 measures had already been taken for the tax's farewell ceremony. Newspaper stories announced the demise of the sick patient with only one short period left. Practitioners uttered a silent sigh along with a cheer. And lawmakers were poised to bury the German trade tax, which is a source of complexity and difficulty in German tax law. Even the timing for the funeral was foreseeable: the Tax Reform 2008.

Yet the Tax Reform 2008 passed legislation[1] without eliminating the trade tax. Instead, the tax has risen like a phoenix out of the ashes; upon enforcement of the Tax Reform 2008, it must be classified as the dominant corporate tax in Germany.

Trade Tax in a Nutshell

The trade tax is one of the oldest taxes in Germany and today is the fourth-biggest revenue raiser. (See Figure 1.)

Before its enactment in the German Empire in 1891, the trade tax was introduced in Prussia; it was copied from the French *patentes* system, which taxed businesses on the grounds of external features like sales, gross profits, number of employees, and capital stock. The *patentes* system can be compared with the U.S. franchise tax.

By the way, the Prussian trade tax is the basis for the "permanent establishment" concept that eventually prevailed all over the world.

The basic idea behind the trade tax is the principle of equivalence, in which the local community receives an appropriate consideration for the costs of infrastructure and other public goods created by a PE.

In the 1960s local communities in Germany generated more than 80 percent of their revenues from the trade tax. This sort of tax monoculture made German communities very vulnerable in times of economic weakness. Therefore, the federal authorities agreed on an income tax and sales tax apportionment in exchange for a share of the trade tax revenue. As depicted in Figure 2, today's community dependency on the trade tax is a little bit less than 50 percent.

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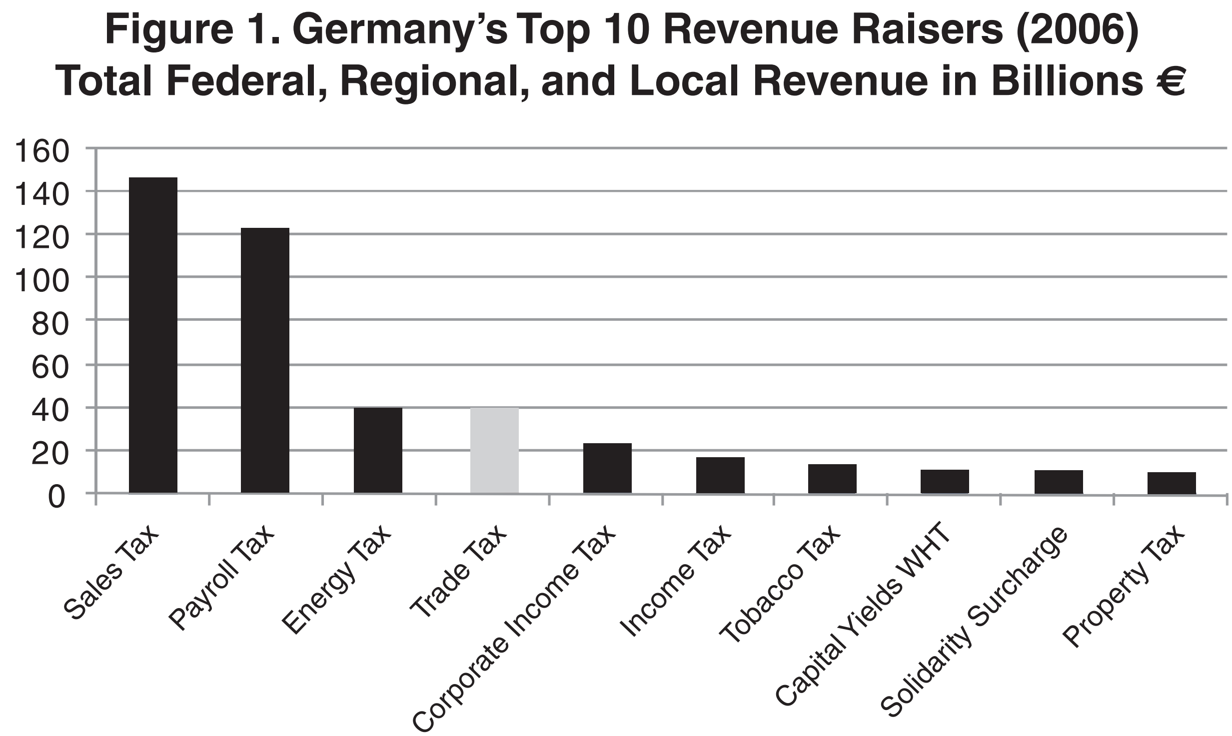
[1]*See* Kessler and Eicke, "The Road Not Taken," *Tax Notes Int'l*, June 11, 2007, p. 1135.



Source: Federal Ministry of Finance.

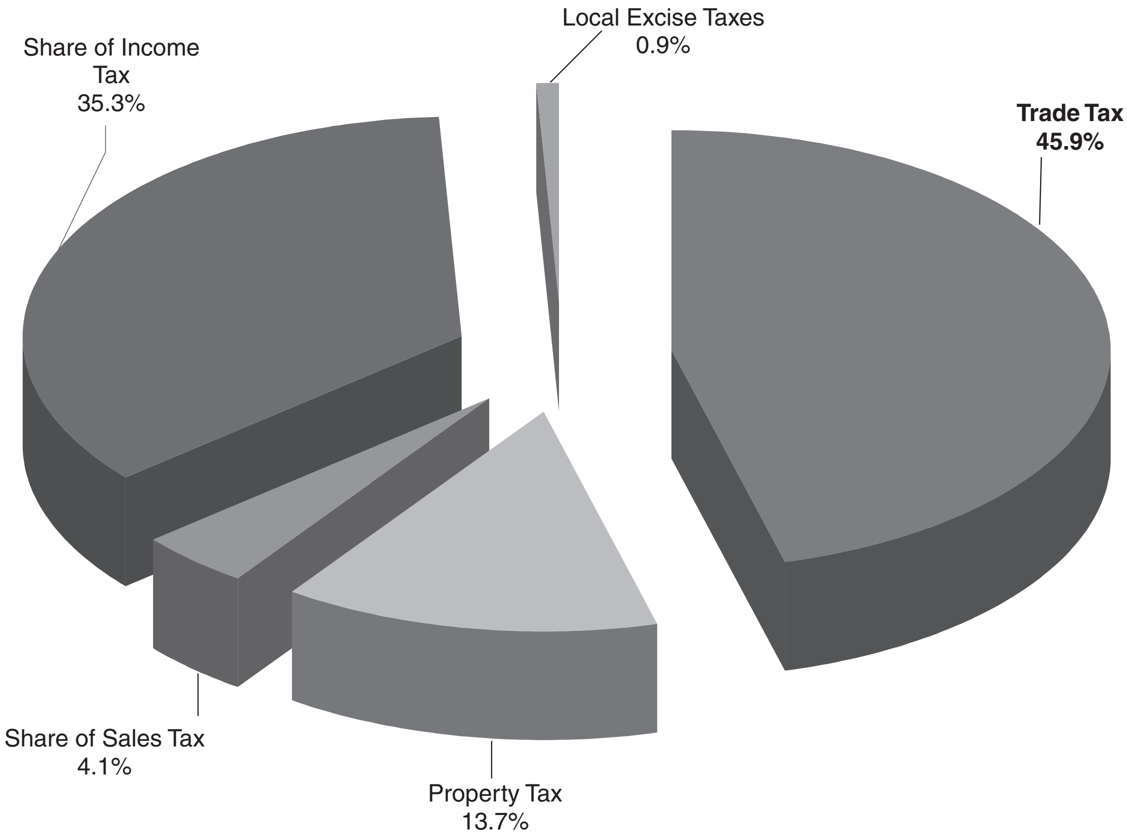
Some of the unique features of the German trade tax are:

- Not all businesses pay trade tax, only those that are considered commercial (*gewerblich*). This excludes self-employed professionals like lawyers, doctors, tax advisers, accountants, architects, and engineers.
- To isolate the earning power of each PE, the underlying corporate or income tax profit is added back (*Hinzurechnungen*) and cut back (*Kuerzungen*). As a tax that focuses on the earning power of the business, the trade tax requires finance neutrality, meaning that the choice of financing (equity or debt) must not result in a different treatment for tax purposes. Accordingly, the current regime adds back, for instance, part of the permanent debts, portfolio dividend income, or rents. The most important cutbacks are the deduction of profits from foreign corporations in the case of a minimum holding of 10 percent (so-called trade tax participation exemption) and the deduction of all foreign PE profits due to the principle of territoriality that is inherent to the German trade tax.
- Under the current regime, the trade tax is deductible from the corporate tax base and the income tax base.
- Partners and sole proprietors can credit their trade tax liability against their income tax liability.
- The underlying trade tax base rate ranges from 1 percent to 5 percent. While the 5 percent rate always applies to corporations, partnerships and sole proprietors are privileged.
- Because each community is free to decide on the tax base rate multiplier (*Hebesatz*), the trade tax is a very popular instrument to attract investments. The only restriction is that the minimum multiplier must be 200 percent to prevent trade tax havens in Germany.

Key Adjustments in 2008

At the beginning of corporate tax reform negotiations, the Great Coalition of Christian Democrats and Social Democrats intended to abolish the trade tax and replace it with a federal and local business tax featuring a unified tax base. The main reason for failure was that the major communities were afraid to lose revenue and therefore opposed this idea.

Figure 2. Revenue of Communities in the State of Baden-Württemberg (2006)



Source: Statistisches Monatsheft Baden-Württemberg 8/2007, p. 45.

Moreover, in the course of debates it became clear that to achieve this goal there would have to be sacrifices of all substantive elements in the trade tax, resulting in an abandonment of the principle of territoriality. Consensus was not reached on such a major step. Instead, the trade tax survived in its original form with some major modifications.

The most important changes are that the trade tax is no longer deductible from the corporate or income tax base. Also, the trade tax burden is 14 percent (down from the current 16.67 percent) when the community applies a 400 percent multiplier. Moreover, the underlying trade tax rate is fixed at 3.5 percent.

From an international perspective, the most important adjustments are that 25 percent of all business-related debt finance costs will be added back. That includes rents, leasing payments, and royalties. Also, the trade tax participation exemption will only apply for holdings of at least 15 percent. As a consequence, participation exemption dividends will be taxed at 1.49 percent and portfolio dividends at 14.79 percent. Yet the net addback balance will only be relevant for the trade tax base above a €100,000 allowance. (See Table 1.)

The Dominant Tax

As Figure 3 shows, the trade tax continues to outperform the corporate income tax revenue.

The reason the trade tax will gain more of an edge over the corporate income tax is that the weaker tax

Table 1. Key Adjustments to Trade Tax

	2007	2008
Trade tax burden (with a 400 percent tax base rate multiplier)	16.67 percent	14 percent
Tax base rate (*Steuermesszahl*)	Between 1 and 5 percent	3.5 percent
Deductibility from corporate or income tax	Yes	No
Addback of debt	50 percent of permanent debt	25 percent of all debt finance costs
Trade tax participation exemption (minimum holding)	10 percent	15 percent
Credit factor for partners or sole proprietors	1.8	3.8

rate cut and an increase of addback elements preserve tax revenue even in times of crisis. (See Table 2.)

Table 2. Adjustments to Tax Burden

	2007	2008
Profit	100.00	100.00
Trade tax (400 percent multiplier)	–16.67	–14.00
Corporate income tax	–20.83	–15.00
Solidarity surcharge	–1.15	–0.83
Overall tax burden	38.65	29.83

As the tax base multiplier is relevant for the eventual trade tax burden, the trade tax rate is above the corporate income tax rate when the multiplier is higher than 429 percent without the solidarity surcharge, or 452 percent including the solidarity surcharge. However, this break-even figure decreases rapidly with an increase of the net addback balance.

Putting these figures in relation to the average multiplier in Germany of 391 percent, and an above-average multiplier in all big German cities (see Table 3), the dominance of the trade tax becomes evident.

Table 3. Trade Tax Throughout Germany

City	Trade Tax Base Multiplier in Percent	Total Corporate Tax Rate (Corporate Income Tax, Trade Tax, Solidarity Surcharge)
Berlin	410	30.175
Frankfurt	460	31.925
Hamburg	470	32.275
Munich	490	32.975

Because of the relative gain in the importance of the trade tax rate, the multiplier will play an even more important role in the future for the total corporate tax burden.

Upsides and Downsides

As a matter of fact, partners do not contribute much to the trade tax revenue, as most of them can fully compensate the liability with the tax credit system. In turn, the paramount trade tax burden is carried by corporations.

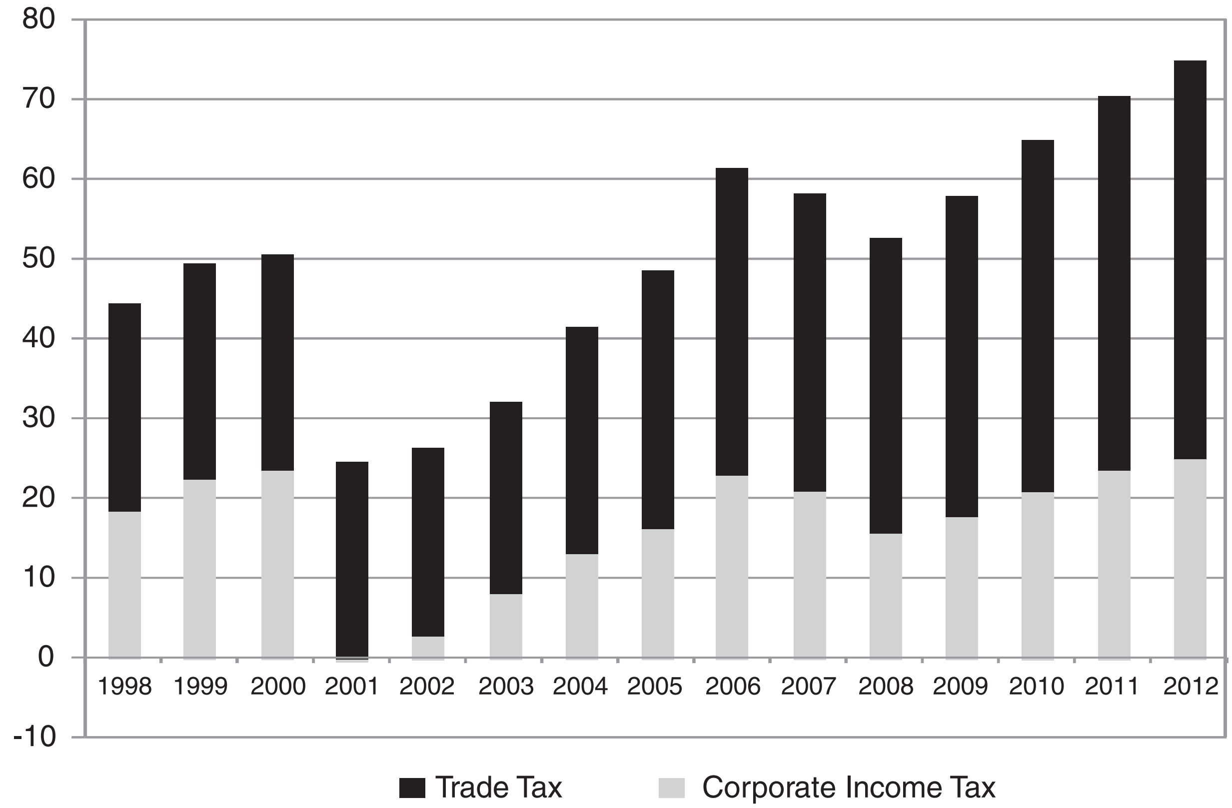
However, corporations are better off after the reform when considering the lowered trade tax base rate of 3.5 percent, which leads to an overall lower tax rate of 14 percent. Yet this benefit also has two major downsides. The first is the nondeductibility of the trade tax, which is supposed to generate extra revenue of €11.4 billion per year according to the official estimates of the German Ministry of Finance. The second is the addback of 25 percent of the entire business-related debt finance costs, which leads to significant substance taxation and means a tax liability despite the losses.

International Tax Implications

One of the major obstacles in the international arena has always been the crediting of foreign taxes against the German trade tax. In practice, foreign taxes paid by a German investor can be credited against the German corporate income or income tax, but not against the trade tax. Excess tax credits or tax credit losses lead to double taxation. The reform will not ease this problem. Yet some authorities put forward convincing arguments for crediting the excess corporate income tax against the trade tax when a double tax treaty provides for a crediting of taxes on income.

Fortunately, this problem does not occur when a U.S., U.K., or Canadian investor in Germany pays trade tax on its German PEs. In that case, the

Figure 3. Development of Corporate Income Tax and Trade Tax Revenue
(€ billions)



underlying German trade tax can be credited against, for example, the U.S. tax liability.

Germany is not, and will not, become a paradise for finance companies. The main obstacle is the addback of all business-related debt finance costs, which makes the German tax treatment of finance companies unattractive in comparison with the Dutch regime or the regime in Luxembourg.

Conclusion

The reform will cement the position of the trade tax as the undisputed dominant corporate tax in Germany. That is because of its substantive taxation elements that generate revenue even in times of no or low corporate income tax payments. The addback of all business-related debt finance costs and the increased burden for the trade tax participation exemption will attract the attention of international tax planners. Moreover, the increasing importance of the tax base multiplier will not only tighten for both domestic and foreign investors the competition between the communities, but will be relevant for the overall corporate tax burden.

Many key reform goals, such as the abolishment of the entire trade tax or the introduction of a unified corporate tax base, have not been reached. That's why life goes on for the German trade tax, which is just about to enter its most precious years. ◆