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Taxes

Direct Taxes

Taxes on Income and Profit

Income Tax

OVERVIEW

1 Determination of Income

Income tax is imposed only

a) on profit deriving from

(1) agriculture and forestry,

(2) industrial business, and

(3) self-employment and

b) on the difference of receipts minus deductible expenses from

(4) dependent employment,

(5) capital investments,

(6) leases and

(7) miscellaneous income.

Any receipt not covered by one of these 7 types of income will stay free of income tax, such as receipts from gifts, inheritances, lottery winnings, damages. Income from capital investments and from leases however will be calculated as part of the income from business activities or from self-employment if, and in so far, the profit generating asset is part of the assets of the business activities or of the self-employment. Whereas legal entities established in Germany are deemed to have income only from industrial business, the difference plays a role for corporations resident outside Germany for the determination of their income from sources inside Germany within the frame of their limited liability to German taxation.

2 Deductible Expenses

Except for very particular cases, there is usually little doubt as to if a particular receipt is covered or not by one of the aforementioned 7 types of income. Discussions with the tax authorities usually concentrate on the deductibility of expenses: As a rule, all expenses can be deducted from the receipts and thus reduce the taxable profit or surplus if, and in so far as the expense has been made or was reasonably intended to generate the receipts.

2.1 Depreciation

Expenses for the acquisition and the production of fixed assets can be deducted only at the rate of depreciation of the individual item.

Ordinary depreciation on real estate is not allowed; ordinary depreciation on buildings is fixed by law at rates from 2 % up to 10 % depending on the age of the building, whether or not the tax payer has acquired/constructed a new or an old building, and the type of building (production facilities/apartment house). In exceptional cases and if situated in certain economically weak regions, such as the former German Democratic Republic, the initial depreciation rate may run up to 50 %.

The rate of depreciation for other assets is calculated over their usual economic lifetime ranging from 3 years up to 25 years, corresponding to 33 % down to 5 % depreciation p.a. In appropriate cases, the ordinary linear depreciation may be replaced by the depreciation calculated on the proportionate use of the asset, during the year (e.g. running time or output of a machinery, kilometres travelled by a truck, and others). Extraordinary depreciation may and must be applied to bring the book value down to the actual value of the asset. Low value tangible fixed assets with costs of acquisition or production not exceeding 410 Euros may be fully written off in the year of acquisition.

2.2 Capitalisation of Production Costs

Expenses incurred in the production of intangible fixed assets may not be capitalised, at all.

Expenses incurred in the production of tangible fixed assets and of stocks (tangible or intangible) to be sold are not fully deductible, the non-deductible part must be capitalised. The amount to be capitalised differs in the accounting rules and in the tax law. The following list details the kind of costs that must and that may be capitalised in both accounting rules and income tax law.

	To be capitalized for	
Kind of expense	Accounting Rules	Tax Law
Cost of material	Obligatory	Obligatory
Cost of Labour	Obligatory	Obligatory
Special cost of produc-	Obligatory	Obligatory

tion		
Reasonable parts of necessary general costs of material	Upon free decision, consistent to preceding year	Obligatory
Reasonable parts of general costs of labour	Upon free decision, consistent to preceding year	Obligatory
Reasonable parts of depreciation of production facilities	Upon free decision, consistent to preceding year	Obligatory
Cost of general administration, social facilities, voluntary social expenses, pension fund	Upon free decision, consistent to preceding year	Upon free decision, consistent to preceding year
Cost of sales	Forbidden	Forbidden

Small businesses are entitled to attribute up to 50 % of the anticipated costs of acquisition of new assets to a special, tax free reserve. Upon the acquisition, which must occur within 4 years after the attribution of the reserve, the amount of the reserve is deducted from the actual cost of acquisition thus reducing the basis for the calculation of depreciation.

Irrespective of the exact date of the acquisition, depreciation may be deducted at the full or half the yearly rate if the asset is acquired during the first 6 months or the second 6 months of the year, respectively. However, if the asset is sold, depreciation must be calculated until the end of the month of sale.

2.3 Setting off Losses

A loss from one business or kind of income may be set off against a profit in another business or income, of the same kind. A resulting loss may be carried back to the preceding year up to an amount of 511,500 Euros, any unused loss must be carried forward to future years. However, losses from one kind of income – e.g. lease of real property – may only to a limited extend be set off against positive income from another kind of income – e.g. self employment.

2.4 Special Deductions for Individuals

Individual tax payers are allowed to deduct expenses for special purposes, some of which are unlimited (such as church tax, tax consulting), whereas others are limited (donations for charitable, ecclesiastical or scientific purposes, life- and health insurance premiums, maintenance for the divorced, for children or for relatives).

3 Tax Rate

The tax tariff is then applied on the resulting ”taxable income”, a rather complicated calculation. For the ease of information, I added a table of income tax under a separate heading.

From Fiscal Year 2002, income tax on taxable income of 55.008 € and more is 48,5 % of the income minus 9,872 €; the corresponding figures for jointly assessed married tax payers are 110,016 € and the deduction is 19,744 € .

From 2004 onward, the tax rate will be 47 % with a deduction of 9.232 €.

From 2005 onward, the tax rate will be 42 % on income of 52,152 € and more with a deduction of 9,232 € (for jointly assessed married tax payers, the amounts are to be doubled).