

Christoph Freichel, Gernot Brähler,
Christian Lösel, Andreas Krenzlin

German Profit Taxes

7th Edition



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UVK Verlag · München

Umschlagabbildung: © iStock MicroStockHub

Bibliografische Information der Deutschen Nationalbibliothek

Die Deutsche Nationalbibliothek verzeichnet diese Publikation in der Deutschen Nationalbibliografie; detaillierte bibliografische Daten sind im Internet über <http://dnb.dnb.de> abrufbar.

6th Edition 2021

DOI: <https://doi.org/10.24053/9783739882284>

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– ein Unternehmen der Narr Francke Attempto Verlag GmbH + Co. KG
Dischingerweg 5 · D-72070 Tübingen

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CPI books GmbH, Leck

978-3-7398-3228-9 (Print)

978-3-7398-8228-4 (ePDF)

978-3-7398-0638-9 (ePub)



Preface

The German income tax law is subject to permanent changes and due to the high pace of reform, the legislator often makes mistakes, or we see ourselves in a situation where enacted regulations are particularly complex. This textbook, which has already been published in its seventh German edition, has now been translated into English language.

This textbook provides beginners with a comprehensive overview of the fundamental aspects of income tax law. After an introduction to income tax law, income tax (Chapter 2) is analysed as a focal point. This includes the characterisation, meaning and principles of income tax, subjective and objective tax liability as well as the temporal allocation of income. Chapter 2 focuses on the explanations relating to the determination of taxable income and the income tax to be determined. Subsequently, the principles of corporate income tax (Chapter 3) and trade tax (Chapter 4) are presented. However, the explanations are not limited to the respective basic principles, but also relate to questions of tax liability, the determination of taxable income or the business profit. Finally, numerous examples are also used to illustrate how these types of taxes are assessed. Chapter 5 is devoted to the approach of the legislator for the implementation in Germany of neutrality of taxation regardless of the legal form. The explanations in this textbook on income tax, corporate income tax and trade tax are supplemented by a so-called comprehensive case study in which the interrelationships of the determination of taxable income or business profit, the respective provisions that may be necessary and the calculation of the relevant tax liabilities are shown, taking into account the special features mentioned in the case.

For the seventh edition, the entire book was revised and updated to adapt it to the current state of legislation, doctrine and jurisprudence. To meet the didactic requirements, the book contains numerous practical examples as well as illustrative figures and tables. At the end of each chapter there is a summary in the form of core statements on key findings, questions, and individual references to literature, which are suitable for in-depth, topic-specific literature study. The comprehensive index is meant to help the reader search for concrete content.

This book is the ideal companion for the preparation for examinations in the bachelor's and master's programmes at universities that are oriented towards business taxation or tax law. It is also ideally suited for self-study. Target groups are therefore students and lecturers in the field of business taxation and tax law. The book is also suitable for English-speaking practitioners (in-

cluding those from abroad) who wish to develop basic knowledge of German Profit taxes useful for their everyday professional life. Assistants in tax consulting, tax clerks as well as property owners with an interest in tax and not least also tax advisers are addressed here.

We would like to thank especially Christoph Freichel's partners Mr. WP StB Dr Matthias Ritzi and Mr. WP StB Matthias Rohr from Moore Treuhand Kurpfalz GmbH Wirtschaftsprüfungsgesellschaft, Steuerberatungsgesellschaft, Mannheim, for the financial support of this book and Mr. Dr Jürgen Schechler from UKV Verlag for the pleasant cooperation. We would like to express our gratitude to our academic staff and student assistants, who have supported us tirelessly and conscientiously in the preparation of the manuscript. In alphabetical order: Mr. Caio Casiraghi, Adv. LL.M., and Ms. Sina Jacob.



We are grateful for any suggestions for improvement, spelling mistakes or suggestions and would like to refer you to the following e-mail addresses:

christoph.freichel@moore-tk.com,
gernot.braehler@gmx.de,
christian.loesel@ingolstadt.de
info@kastl-krenzin.de.

The book is based on the legal status 01.07.2022.

*Christoph Freichel
Gernot Brähler
Christian Lösel
Andreas Krenzin*

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List of abbreviations

AB	Assessment basis
AG	Aktiengesellschaft (stock company)
AltEinkG	Alterseinkünftegesetz (German Retirement Income Act)
AO	Abgabenordnung (The Fiscal Code of Germany)
AP	Assessment period
AStG	Außensteuergesetz (German International Transactions Tax Act)
BAföG	Bundesausbildungsförderungsgesetz (German Federal Education Assistance Act)
BewG	Bewertungsgesetz (German Valuation Act)
BFH	Bundesfinanzhof (Federal Fiscal Court)
BGB	Bürgerliches Gesetzbuch (German Civil Code)
BMF	Bundesministerium der Finanzen (German Federal Ministry of Finance)
BStBl	Bundessteuerblatt (German Federal Tax Law Gazette)
cf.	see
DIW	Deutsches Institut der Wirtschaftsprüfer (German Institute of Auditors)
EEA	European Economic Area
EFTA	European Free Trade Association
e.g.	for example
ErbSt	Erbschaftsteuer (Inheritance Tax)
Est	Einkommensteuer (Personal income tax)
EstDV	Einkommensteuer-Durchführungsverordnung (German Implementing Ordinance for Income Tax)
EstG	Einkommensteuergesetz (German Income Tax Act)
EstH	Einkommensteuer-Hinweise (German notes on income tax law)
EstR	Einkommensteuer-Richtlinien (German guide to income tax law)
et seqq.	and the following
EU	European Union
FG	Finanzgericht (Fiscal Court)
GewSt	Gewerbesteuer (trade tax)
GewStDV	Gewerbesteuer-Durchführungsverordnung (German Implementing Ordinance for Trade Tax)
GewStG	Gewerbesteuergesetz (German Trade Tax Act)
GewStR	Gewerbesteuer-Richtlinien (German guide to trade tax law)

12 List of abbreviations

GG	Grundgesetz (German Constitutional Law)
GmbH	Gesellschaft mit beschränkter Haftung (similar to a limited liability company)
GrEST	Grunderwerbsteuer (land transfer tax)
GrSt	Grundsteuer (land tax)
HGB	Handelsgesetzbuch (German Commercial Act)
i.a.w.	in accordance with
i.c.w.	in conjunction with
i.e.	meaning
KapEST	Kapitalertragsteuer (capital yields tax)
KfzSt	Kraftfahrzeugsteuer (motor vehicle tax)
KG	Kommanditgesellschaft (similar to a limited partnership)
KGaA	Kommanditgesellschaft auf Aktien (similar to a partnership limited by shares)
KSt	Körperschaftsteuer (corporate income tax)
KStG	Körperschaftsteuergesetz (German Corporate Income Tax Act)
KStR	Körperschaftsteuer-Richtlinien (German guide to corporate income tax law)
lit.	letter
LStDV	Lohnsteuer-Durchführungsverordnung (German Implementing Ordinance for Wage Tax)
LStR	Lohnsteuer-Richtlinien (German wage tax guidelines)
max.	maximum
MinöSt	Mineralölsteuer (petroleum tax)
no./nos.	number/numbers
OHG	Offene Handelsgesellschaft (similar to a general partnership)
p.a.	per annum
P&L	Profit and loss account
p./pp.	page/pages
Sec./Secs.	Section/Sections
sent.	sentence
SolZ	Solidaritätszuschlag (solidarity surcharge)
UMTS	Universal Mobile Telecommunications System
vs.	versus
VAT	Value-added tax

1 Introduction to German profit tax law

1.1 The importance of taxes

Taxes form an important part of every citizen's financial endeavours. The liability to pay taxes accompanies every citizen from the cradle to the grave. The tax liability is imposed by the polity to finance the services performed by the state and influences citizens' economic dealings. The state must observe certain basic principles when levying taxes, e.g., the principles of legality and uniformity. In particular, direct taxation is supposed to be based on the economic capacity of the taxpayer. The state may not unduly call on individual citizens (strangulation effect) if it desires to participate in the success of the private economy in a sustainable manner. Non-uniform taxation can lead to evasive reactions by the economic actors and presents credibility and legitimacy problems that, inter alia, can lead to a decrease in tax revenue.

Thus, a state must take care to levy taxes so as to reflect the relationship between the legal protection of ownership and the social obligation arising from ownership in a legal and comprehensible manner which is seen to be just. The opposition of the objectives and interests that play a role in taxation must be taken into account in levying taxes. Economic actors want to and must reduce the tax liability, inter alia because of the pressure of globalization. On the other hand, taxes finance tasks whose fulfilment can be for the benefit of the economic actors and provide the State with the opportunity to intervene in the economic process, inter alia, for the benefit of all.

1.2 Tax burden and tax justice

Modern industrial states fulfil a number of political tasks of a social, regulatory and economic nature. The extent of the tasks vested in the respective political system is always reflected in its so-called Staatsquote, which indicates the ratio of government expenditures to gross national product (GNP). In Germany, this ratio was 50,8 % in 2020:

$$\begin{array}{l} \text{Public} \\ \text{expenditure quota} \\ (2020) \end{array} = \frac{\text{Government expenditures}}{\text{Gross national product}} = \frac{\text{€ 1,710.4 billion}}{\text{€ 3,368.0 billion}} = 50.8 \%$$

Figure 1: Ratio of government expenditures to the GNP for Germany 2020

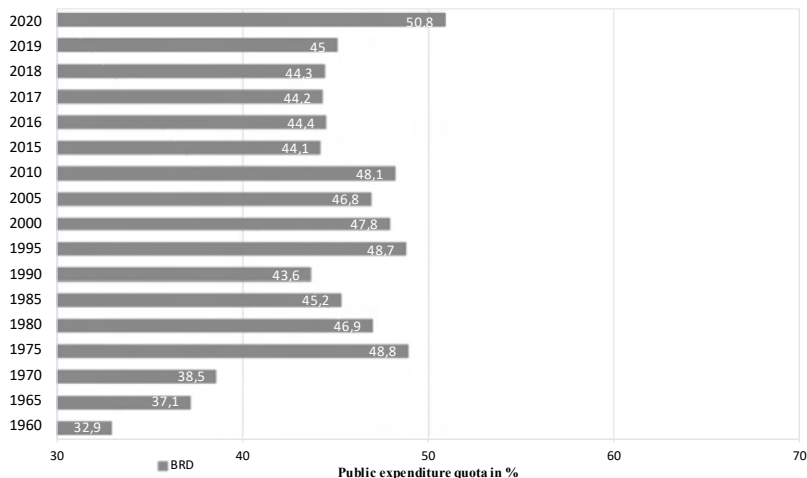


Figure 2: Development of the Expenditure-GNP ratio from 1960 to 2020

States levy contributions, predominantly in the form of taxes, to finance the public services. A high public expenditure quota generally means that the economic actors are subject to an increased liability to pay taxes and contributions. This liability to pay taxes and contributions is expressed by the so-called tax ratio which indicates the ratio of taxes and social contributions to the gross national product. In 2020, this tax ratio amounted to 41,0%:

$$\text{Tax ratio (2020)} = \frac{\text{Taxes + levies}}{\text{Gross national product (GNP)}} = \frac{\text{EUR 739.7 billion} + \text{EUR 641.2 billion}}{\text{EUR 3,368 billion}} = 41,0 \%$$

Figure 3: Tax ratio in Germany 2020

Taxes influence the people's economic activities and change their consumption, investment and savings habits. Thus, taxes must be arranged in a "fair" manner. "Fair" means that the circumstances of each individual case must be taken into account, as only specially tailored rules prevent generalized and therefore unfair legal consequences in individual cases. However, the more tax laws take details into account, the more complex they become and the more difficult they become to apply or carry out. As is the case when there are too few regulations, the complexity of tax provisions caused by the increasing number of rules for specific cases leads to injustices because only those who have access to correspondingly qualified advice are able to make fiscally optimal arrangements. Those taxpayers who receive no or poor advice are thus at a disadvantage compared to those who receive good advice, because the former are unable to take advantage of the possibilities to avoid paying taxes. The

term “Dummensteuer” (idiot tax) has also been used in this context. The term “fair” also means not over-regulating the system of taxation, but rather keeping it manageable and comprehensible for the majority of taxpayers.

In addition to excessive regulations for individual cases, another reason for the complexity of our tax system is the fact that the assessment of taxes does not only serve as a source of income for the State, but rather is used economically and socio-politically to steer the actions of individuals. Taxes are meant to guide behaviour. Instead of enacting imperatives and prohibitions, the legislature encumbers undesired behaviour with additional taxes and promotes desired behaviour and those goods worthy of such promotion (so-called merit goods) with tax relief (e.g., lower value-added tax of 7% for foodstuffs and magazines, instead of the normal 19%). Thus, the State not only pursues fiscal interests, but also steering objectives as well (e.g., the restriction of cigarette consumption with the tobacco tax, or the promotion of energy saving with the ecology tax).

1.3 The three tax disciplines

In light of the allocative and distributive importance of taxes for the State and its economic actors, several scientific research facilities address their effects, their application, or their distribution. The tax disciplines can be broken down into the three sub-areas: Tax Law, Financial Science, and Business Taxation. The object of experience for all three disciplines is the phenomenon “taxes,” although the respective subject matters of their research differ. The demarcations between the individual areas are fluid.

The discipline of **Tax Law** considers taxation to be a legal process. This discipline concentrates on the legal aspects of taxation and is concerned with the relationship between the State and its citizens with regard to taxation. The subject matter includes issues in the construction of tax provisions or the examination of their conformity with the constitution and/or the law of the European Union.

The discipline of **Financial Science** forms part of political economics and is thus macro-economically oriented. The economic actions of the State form the object of knowledge, to the extent that earnings and expenses are included. The discipline of Financial Science addresses, for example, issues involving the just distribution of tax revenue or the minimization of negative effects of taxation on production, consumption and competition (influence on the allocation of resources, minimization of deadweight loss).

The subject matter of **Business Taxation** is the examination of effects of taxation on the business activities of companies. There are five main scientific areas of research within the discipline of business taxation:

- Problem-oriented assessment of tax law (presentation of legal norms): Knowledge of the most important national and international tax provisions is of fundamental importance for the discipline of business taxation.
- Theory of tax effects in business economics: Analysis and description of the influence of taxation on the variables of fundamental importance to decisions made by economic actors.
- Theory of tax planning in business economics: Advice for the decision-makers of a company in exercising options under tax law and in the arrangement of planned circumstances in order to minimize the total tax burden.
- The evaluative-normative theory of business taxation: Critical opinions on the current state of tax law (*de lege lata*) as well as planned changes (*de lege ferenda*).
- Empirical research in business taxation: The use of empirical methods e. g. surveys, experiments, analysing tax-relevant data, in order to state assumptions about the actual impact of taxation on the economic actors.

It is an indispensable prerequisite to first examine tax law in terms of a portrayal of legal norms because tax law constitutes, on the one hand, the framework within which fiscal arrangements are made and, on the other hand, the instrument of such arrangements. Building on this, the effects of taxation can be examined for subsequent targeted tax planning afterwards.

Note

There are three different tax disciplines:

- Tax Law
- Financial Science and
- Business Taxation

1.4 The tax system

1.4.1 Earnings of the state

The public sector is financed by public and extraordinary earnings. Ordinary earnings end up with the State and are thus available to the State indefinitely. A difference must be drawn between earned income of the State and (sovereign) compulsory levies. Earned income of the State is acquired by the public sector's participation in the market, e.g., by way of private businesses with public shareholding (e.g., Deutsche Post, Deutsche Bahn, Deutsche Telekom,

as well as banks, research centres, harbour companies, airport companies and construction companies, etc.). Compulsory levies are divided into taxes, fees, contributions and special duties. Extraordinary earnings are only available to the State temporarily and must be paid back when a certain deadline has been reached. These extraordinary earnings also include public borrowing.

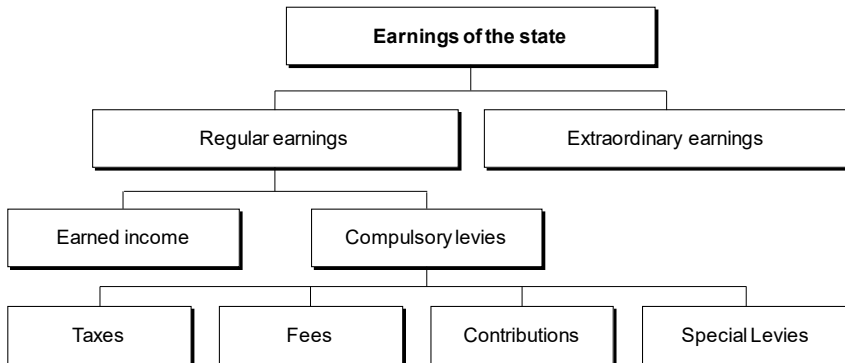


Figure 4: Financing Sources of the state

1.4.1.1 Taxes

Taxes make up the largest portion of state earnings in all industrial countries, including Germany. According to the legal definition contained in Sec. 3 (1) AO (The Fiscal Code of Germany), taxes are “payments of money that do not represent counter-performance for a particular performance and that are imposed by a society on all those who fulfil the statutory requirements for the tax liability, in order to generate income”. The term “tax” possesses the following characteristics:

- **Compulsory levies:** Taxes are levied by public bodies by virtue of their financial sovereignty. The taxpayer is to pay these levies if certain statutory requirements are fulfilled. It is not voluntary.
- **Payments of money:** According to their definition, taxes are payments of money, not performances in kind. They can be payment obligations that occur once (e.g., inheritance tax, and land transfer tax GrESt) or periodically recurring payment obligations (e.g., income tax, corporate income tax, and trade tax).
- **No counter-performance:** Taxes neither establish an entitlement to counter-performance by the state, nor is the level of taxes calculated directly according to the public services received by the taxpayer. Thus, taxes are not calculated in accordance with the equivalence principle.

- **Public Law Personality:** Tax sovereignty is a prerequisite to levying taxes. In Germany, this is vested in the federal government (Bund), the federal states (Länder), the municipalities (Gemeinden) as well as those religious communities that possess the status of a corporation under public law.
- **Statutory basis:** Taxes must be levied from all who fulfil the statutory requirements for the tax liability. Taxes may not be levied in the absence of a statutory basis.
- **Realization of earnings:** Also as secondary objective: Taxes not only serve in the realization of earnings, but also economic- and socio-political (steering-) purposes. For this reason, the discipline of Financial Science also points out the possibility of using taxes to influence the behaviour of the taxpayers (e.g., “ecology tax”).

The levy of taxes is accompanied by the so-called ancillary expenses related to taxes. According to Sec. 3 (4) AO, these are late fees, interest, surcharges on arrears, administrative fines, and costs. In doing so, the legislature does not intend to realize earnings, but rather to cause a certain behaviour on the part of the taxpayer. Ancillary expenses related to taxes are imposed if the tax-related obligations are not or are belatedly fulfilled by the taxpayer.

1.4.1.2 Fees

Fees (under public law) are also levies by the State for the realization of earnings. In contrast to taxes, however, the performance by the citizen (in the form of paying a fee) is matched by a counter-performance by the State. Thus, they are levied for the actual, individual use of public facilities; the equivalence principle applies. A distinction must be made between the following:

- Administrative fees (e.g., passport fees, motor vehicle registration fee),
- Utilization fee (e.g., road tolls, entrance fee for the local public swimming pool, trash
- collection fee); and
- Licensing fees (e.g., for concession fees, UMTS-license fees).

1.4.1.3 Contributions

Contributions are expense reimbursements imposed for the potential utilization of the concrete services performed by public facilities. They also serve as financing. Contributions only entitle the party liable to pay to the possibility of utilizing the services performed, whereby a concrete counter-performance is rendered in the case of fees. The party liable to pay contributions must fulfil the payment obligation, even if he does not take advantage of the counter-performance (e.g., tourism levy).

1.4.1.4 Special levies

Special levies are levies that are not assessed to cover the general fiscal requirements of the state, but rather serve to finance special tasks and are only levied from certain groups of citizens. In addition to financing, steering objectives are also pursued; in doing so, an incentive is intended for a certain behaviour and undesirable behaviour is to be sanctioned. An example of this is the equalisation levy in accordance with the German Severely Handicapped Persons Act (Schwerbehindertengesetz) paid by the employer if a certain minimum number of persons with severe disabilities is not employed.

1.4.2 Classification of the tax types

The tax system consists of all individual taxes levied as well as the way in which they are levied. Considering the numerous federal, regional, and communal taxes that are levied in Germany from different taxpayers, for different taxable objects, and on different assessment bases in different forms – partially with dependencies and interdependencies – the German tax system is a very complex system. The law of taxes and levies for the Federal Republic of Germany consists of over 100 laws and ordinances as well as several hundred statements made by the German Federal Ministry of Finance (BMF). Additionally, there are innumerable laws that are not tax laws per se, but are of relevance to tax matters.

Scholars have developed several different approaches to systemizing the (individual) taxes.

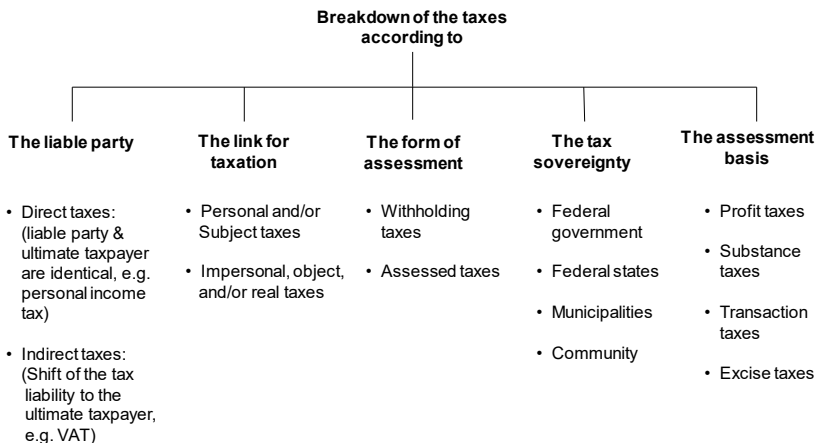


Figure 5: Approaches of systematization

- **Direct and indirect taxes**

The distinction originates from the discipline of financial sciences and is related to the possibility provided by the legislature to shift tax liability. In the case of direct taxes, the tax debtor, the ultimate taxpayer, i.e., the party that ultimately bears the tax burden, and the taxpayer are identical (e.g., income tax). The intended shift of the tax liability from the tax debtor to the ultimate taxpayer is characteristic of indirect taxes. Accordingly, in the case of value-added tax, although the business owner is the tax debtor and the taxpayer, it is the final private consumer, who is to be encumbered financially (ultimate taxpayer).

Note

Direct taxes: No shift of tax liability is envisaged

Indirect taxes: Shift of tax liability is envisaged

- **Personal and impersonal taxes**

Personal and/or impersonal taxes are taxes that allow for characteristics related to individuals (e.g., marital status, age). The most important personal taxes are personal income tax (Einkommensteuer – ESt), inheritance tax (Erbschaftsteuer – ErbSt) as well as the corporate income tax (Körperschaftsteuer – KSt). Another fundamental characteristic of the personal taxes is the distinction between the unlimited and limited tax liability. In the case of impersonal taxes, object-related taxes or real-estate taxes, the amount of taxes is generally determined solely by characteristics related to the object. The trade tax (Gewerbesteuer – GewSt) and the land tax (Grundsteuer – GrSt) are examples of impersonal taxes.

- **Withholding and assessed taxes:**

With Wage tax and capital gains tax, withholding taxes are levied from wage and/or salary and capital gains, e.g., on a monthly basis to cover the general fiscal requirements of the state. The taxes are otherwise levied by way of assessment, generally by exemption of the respective withholding tax.

- **Classification according to economic factors**

In examining the economic factors and/or the assessment basis of the taxes, the following groups of taxes can be identified:

- Profit taxes (the economic success forms the assessment basis of the taxes, e.g., personal income tax, corporate income tax and trade tax),

- Substance taxes (the amount of funds form the assessment basis of the taxes, e.g., land tax and deferred transaction tax),
- Transaction taxes (are generally based on legal transactions, e.g., land transfer tax),
- Excise tax (are generally based on consumption by the consumer, taxation is usually carried out at the level of the producer, e.g., tobacco, alcohol, electricity and energy taxes).

Value-added tax cannot be clearly classified according to the scheme above. Technically, it is arranged like the transaction tax and takes into account the change of disposing capacity. According to the intentions of the law, it is, however, an excise tax because the final consumer is to be encumbered.

Additional classification factors were developed especially within the discipline of Financial Sciences. In this respect, a distinction can be made, for example, between the parties entitled to the revenue (federal, regional, communal or community taxes) or according to the unit of measure forming the assessment basis (specific taxes or ad valorem taxes). Specific taxes are related to physical magnitudes, such as quantity, weight or lot size (e.g., litres for petroleum tax, kWh for electricity tax). In contrast, the assessment basis of ad valorem taxes are values (e.g., the taxable income in the case of personal income tax).

1.4.3 Taxation terminology

1.4.3.1 Taxpayer and/or taxable subject

The taxable subject is the person, who is subjected to taxation. The taxable subject can be a natural person (personal income tax) as well as a legal entity (corporate income tax), such as a capital company. The term “taxable subject” is synonymous with “tax debtor” and “taxpayer”.

1.4.3.2 Subject of taxation and/or taxable object

The subject of taxation and the taxable object are used synonymously and can be used to describe an object, an action or a sum of money. The existence of the subject of taxation and/or the taxable object constitutes the tax liability. For example, the personal income tax and/or the corporate income tax are based on the income earned. An economic asset (e.g., real property, business establishment, motor vehicle) or an economic event (e.g., turnover) can be the connecting factor for taxation.

1.4.3.3 Tax base

The tax base provides information on the extent to which a subject of taxation is subjected to taxation. It is the quantified object of taxation. The assessment

basis is often expressed in money (e.g., income). It can, however, also be a technical and/or physical magnitude, such as cubic capacity (e.g., motor vehicle tax – KfzSt) or litres of fluid (e.g., MinöSt).

1.4.3.4 Tax threshold, tax allowance, deductible amount

A **tax threshold** is the part of the assessment basis up to the maximum value of which taxes are not levied. If the tax threshold is exceeded, the entire assessment basis shall be subjected to taxation. The tax threshold on private sales transactions of € 600 in accordance with Sec. 23 (3) sent. 5 of the German Income Tax Act (Einkommensteuergesetz – EStG) is the classic example. The intended purpose of the tax threshold is to relieve the tax administration which should not be bothered with insignificant amounts.

A **tax allowance** remains tax free regardless of the amount forming the assessment basis. It is an amount that can be deducted in the calculation of the tax base, but which is generally only granted to the extent that it does not cause the assessment basis to be below zero. An example is the basis tax allowance of € 10,347 (2022) in accordance with Sec. 32a (1) sent. 2 no. 1 EStG that exempts the taxpayer's subsistence level from taxation. On account of the progressive character of personal income tax, tax allowances benefit taxpayers with high income more than taxpayers with low income because, when earning a higher income, the resulting reduction of the assessment basis and the tax rate is larger than it is when less income is earned.

A **deductible amount** is not deducted from the assessment basis but rather directly from the tax debt. In doing so, it directly reduces the amount of taxes to be paid. While the tax allowance leads to more relief in a progressive tax scale with an increasing assessment basis, the deductible amounts provide relief to all taxpayers to the same degree and are thus perceived as more just. An example for a deductible amount is the deduction of donations to political parties by natural persons amounting to 50 % of the expenditures, at most € 825 (cf. Sec. 34g sent. 1 no. 1 and sent. 2 EStG).

Note

A tax threshold is the part of the assessment basis, up to the maximum value of which taxes are not levied.

A tax allowance is the part of the assessment basis that is exempted from taxation.

A deductible amount is deducted from the taxpayer's tax debt.

1.4.3.5 Tax rate and tax scale

The **tax rate** indicates what percent of the assessment basis or what absolute amount of money per unit of the assessment basis is levied as taxes by the fiscal authorities. The term tax scale is used if the tax rate is not constant for the entire assessment basis. Thus, a tax scale consists of a sequence of tax rates.

Tax scales can be simple tax scales (dependent on only one variable, e.g., the personal income tax scale, which is only dependent on the amount of taxable income) or combined scales (dependent on more than one variable, e.g., the inheritance tax scale, which is dependent on the amount of the inheritance as well as the degree of relationship). The scales of personal taxes are usually constructed progressively, i.e., the tax rate and the resulting average tax burden increase with the assessment basis.

The **basic tax rate** is the tax rate that must be paid for the first Euro of the taxpayer's assessment basis.

On the other hand, the **top tax rate** is the highest tax rate provided for in a tax scale (= maximum marginal tax rate).

The **average tax rate** results from the amount of taxes to be paid divided by the respective assessment basis. If the tax rate is expressed as a percentage, the result is to be multiplied by a factor of 100.

$$\text{Average Tax Rate} = \frac{\text{Tax}}{\text{Tax basis}} \quad (\times 100)$$

The **marginal tax rate** or the marginal rate of tax is the tax rate at which the last (highest) unit of the assessment basis achieved is taxed. The marginal tax rate results from the first derivative of the tax function.

$$\text{Marginal Tax Rate} = \frac{\Delta \text{Tax}}{\Delta \text{Tax basis}} \quad (\times 100)$$

The **differential tax rate** is the average tax rate levied on an additional part of the assessment basis (BZ). If the taxes on the assessment basis including BZ are depicted as SZ and as S for the taxes without this part of the assessment basis, the differential tax rate is calculated as $(SZ - S)/BZ$.

$$\text{Differential Tax Rate} = \frac{S_z - S}{B_z} \quad (\times 100)$$

Note

Only the top tax rate in Germany is 45 %. The average tax rate is regularly (significantly) lower due to the tax tariff.

The scale can be designed as a **calculation scale** or as a **threshold scale** (graduated scale). In the calculation scale, the rate that applies to the last unit of taxation shall apply to the entire assessment basis. In the case of the threshold scale or graduated scale, the assessment basis is broken down into portions, to which a certain tax rate is then applied respectively. The personal income tax scale in Germany is designed as a threshold scale. In 2022 the following scale applies:

- From € 0 to € 10,374: Basis tax allowance; not subject to taxation (cf. Sec. 32a (1) sent. 2 no. 1 EStG)
- From € 10,348 to € 14,926: Transition to **linear-progressive development**. The marginal tax rate increases from a basic tax rate of 14 % to 23.97 % (cf. Sec. 32a (1) sent. 2 no. 2 EStG).
- From € 14,927 to € 58,596: Linear-progressive development with a **quick increase in the marginal tax rate** up to 42 % (cf. Sec. 32a (1) sent. 2 no. 3 EStG).
- From € 58,597 to € 277,825: Proportional development with a marginal **tax rate** of 42 % (cf. Sec. 32a (1) sent. 2 no. 4 EStG).
- Above € 277,826: Proportional development with a **top tax rate** of 45 % (cf. Sec. 32a (1) sent. 2 no. 5 EStG), so-called wealth tax (Reichensteuer).

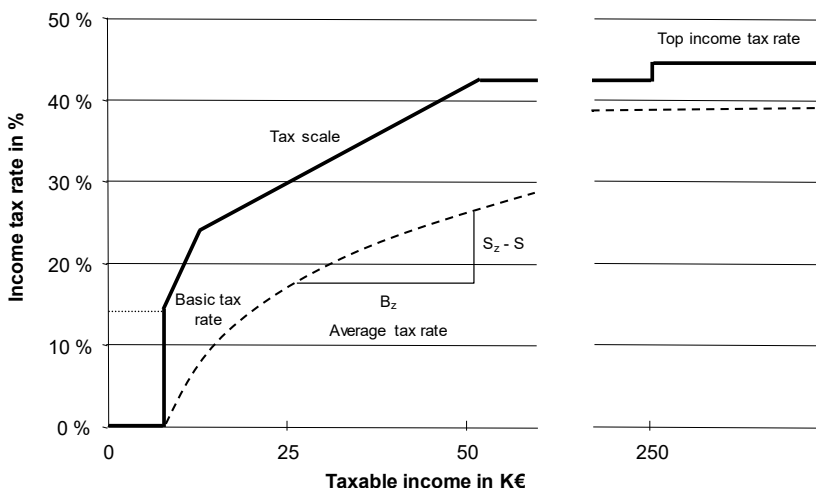


Figure 6: Tax scale in 2022

On top of income tax, the German state levies from certain tax subjects an additional tax that is based on the amount of income tax (Solidaritätszuschlag - solidarity surcharge, or Soli). These taxes are charged by 5,5 % on the assessed income tax (cf. Sec. 4 (1) SolZG) and initially applied to nearly all tax subjects. However, a new law (from December 10, 2019) was passed which significantly raised exemption limits from that additional tax (cf. Sec. 3 SolZG). Since it is effective nearly 90% of the current taxpayers were exempted from paying Soli. Only high-income earners will still have to pay the surcharge.

1.4.4 Tax sovereignty

The distribution of the tax revenue to the federal government, the federal states and the municipalities is regulated in Art. 106 of the Basic Constitutional Law of Germany (GG). Most of the tax types are assigned exclusively to an individual federal, regional, or local authority (Gebietskörperschaft) named in the Basic Constitutional Law (divided tax system). The revenue from the most profitable tax types, especially the personal income tax, corporate income tax and value-added tax (community taxes), is, however, divided between the federal government and the federal states according to a set distribution key (combined tax system). The advantage of the combined system is that the distribution of the tax revenue to the regional authorities leads to the avoidance of multiple taxation by different levels. The tax sovereignty over the tax revenue can be classified as follows:

Note

The personal income tax and the corporate income tax are community taxes.
The land tax and the trade tax are communal taxes.

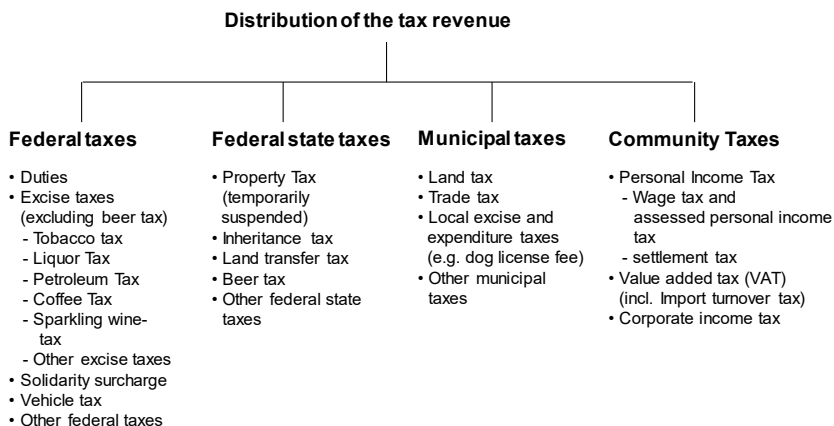


Figure 7: Classification of taxes according to the tax sovereignty

Summary

- ▶ The expenditures of the state are predominantly financed by levying taxes. The legal definition of tax is contained in Sec. 3 (1) of the Fiscal Code of Germany (AO).
- ▶ Different disciplines of science have taxes as object of knowledge.
Tax types:
 - Impersonal and personal taxes
 - Direct and indirect taxes
 - Classification according to economic factors
 - Classification according to the regional authorities entitled to the revenue
- ▶ Taxation terminology:
 - Taxpayer and/or taxable subject
 - Subject to taxation and/or taxable object
 - Tax base
 - Tax threshold/tax allowance/deductible amount
 - Tax rate/tax scale

Questions

1. Which disciplines of science deal with taxes?
2. What types of income does the state receive?
3. What kinds of levies can be distinguished?
4. What is a tax allowance, what is a tax threshold and what is a deductible amount? What is the difference between the three?
5. What is the difference between the marginal tax rate, average tax rate and differential tax rate?
6. What taxes are levied solely by the federal governments, by the federal states or by the municipalities? What taxes are levied in the combined system?

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2 Personal income tax

2.1 Basic principles of personal income tax

2.1.1 Characterization, importance and principles of personal income tax

2.1.1.1 Legal basis

Personal income tax is levied in accordance with the law. According to Sec. 4 of the Fiscal Code of Germany (AO), “Law is every legal norm”. Taxation without a legal basis is not permitted. The legal bases of the personal income tax include the following:

- **Formally enacted laws:**
 1. **Constitution:** The German Basic Constitutional Law of 23 May 1949
 2. **General laws:** E.g. the Fiscal Code of Germany (Abgabenordnung – AO) or the Income Tax Act (EStG),
- **Subordinate legislation:** The German Implementing Ordinance for Income Tax (Einkommensteuer-Durchführungsverordnung – EStDV) and the German Implementing Ordinance for Wage Tax (Lohnsteuer-Durchführungsverordnung – LStDV).

Laws and subordinate legislation are generally binding. The following also have a substantial influence on legal practice:

- The decisions of the German Federal Fiscal Court (BFH) and the German Fiscal Courts (FG)
- **Administrative provisions:** Income tax guidelines (Einkommensteuer-Richtlinien – EStR), wage tax guidelines (Lohnsteuer-Richtlinien – LStR), official statements from the German Federal Ministry of Finances (Bundesministerium der Finanzen – BMF), decrees of the federal states or orders from the regional tax offices (Oberfinanzdirektionen).

The decisions of the courts are only binding for the respective case. The decisions do have influence beyond the individual case, however, because it must be assumed that the courts will make the same decision in similar cases. The administrative provisions are only binding for the tax administration, however, not for the taxpayers.

Note

Administrative provisions are only binding for the tax administration, not taxpayers.

2.1.1.2 Characteristics and demarcation of the personal income tax

The personal income tax belongs to the group of profit taxes, as does the corporate income tax and the trade tax. This group includes all types of taxes in which economic success forms the tax base. The magnitudes of success that are examined thereby include the profit, the revenue, the surplus or even the income.

As a personal tax, the personal income tax is linked with the tax subject “natural person.” In doing so, the principle of the personal ability to pay is accommodated by taking into account the taxpayer’s personal circumstances in the calculation of the income (e.g., the subsistence level as basis tax allowance under Sec. 32a (1) sent. 2 no. 1 EStG and the classification of insurance premiums for personal insurances as special expenses in accordance with Sec. 10 (1) nos. 3 and 3a in conjunction with (i.c.w.) (4) EStG. The so-called taxable income (zu versteuerndes Einkommen – z.v.E.) forms the assessment basis of the personal income tax. As a personal tax, the personal income tax may not be deducted from its own assessment basis in accordance with Sec. 12 no. 3 EStG. According to Sec. 10 no. 2 of the German Corporate Tax Code (KStG), the same applies to the corporate income tax. As an impersonal tax, the trade tax is based on the ability of the (commercial) enterprise as the taxable subject to pay. The assessment basis is the trade income. Although trade tax is levied for business purposes and therefore represents a business expense, it cannot be deducted as a business expense when calculating profits (cf. Sec. 4 (5b) EStG).

	Personal and corporate income tax	Trade tax
Fiscal link	taxable subject (personal tax), personal ability to pay	taxable object (property/real tax), objective ability to pay
Assessment basis	Taxable income	(objectified) trade income
Deductibility from the assessment basis	not deductible	

Table 1: Differentiation of the profit tax types

2.1.1.3 Fiscal and economic importance

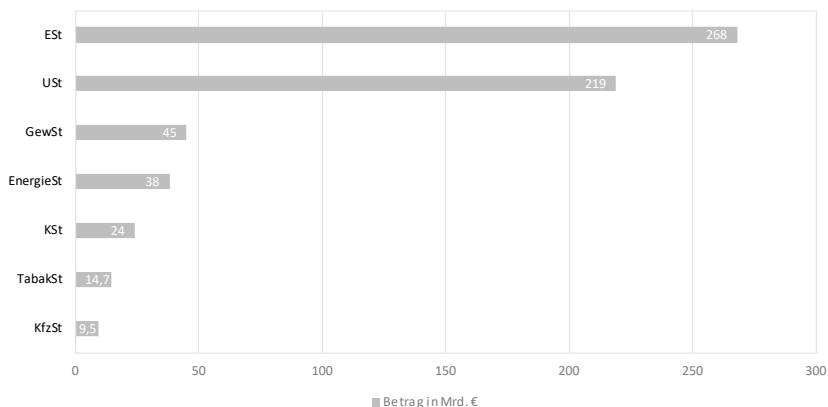


Figure 8: Revenue from selected types of German taxes in 2020

In 2020, the revenue from income tax amounted to approx. 268 billion. Thus, together with value-added tax, it is the most important tax.

2.1.1.4 Principles of income taxation

The ability-to-pay principle is fundamental to the German tax system and is substantiated by several sub-principles. Although these principles have not been codified *expressis verbis*, i.e., they are not written in the law, they are, however, reflected in numerous provisions:

- **The principle of taking into consideration the personal ability to pay:** Each taxpayer should participate in providing tax revenue according to his ability to pay. How the ability to pay should be measured is the subject of debate. Indicators, such as income, assets or consumption, are often used. There is consensus that taxpayers in the same situations must be taxed equally (**horizontal tax equity**), while taxpayers in different situations are – corresponding to the character of the difference – to be treated differently (**vertical tax inequity**).
- **Objective net income principle:** The assessment basis of taxation is reduced by expenditures which are made to generate income and which stand in direct economic relation to this generation. Losses are also taken into account in the determination of the income because they lower the taxpayer's ability to pay. Hence, losses in one type of income may be offset with earnings in other types of income. The deductibility of business expenses (Sec. 4 (4) EStG) and income-related expenses (Secs. 9, 9a EStG) as