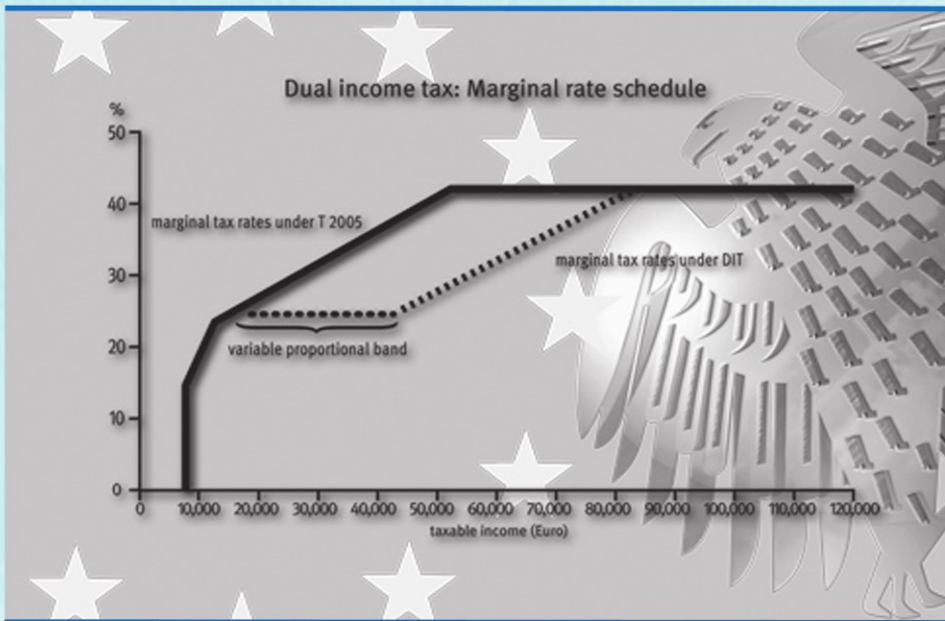


ZEW Economic Studies

German Council of Economic Experts
Max Planck Institute for Intellectual Property,
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Centre for European Economic Research

Vol. 39

Dual Income Tax



A Proposal for Reforming Corporate and Personal Income Tax in Germany

ZEW Economic Studies

Publication Series of the Centre for
European Economic Research (ZEW),
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A Proposal for Reforming Corporate
and Personal Income Tax in Germany

Physica-Verlag
A Springer Company

ZEW
Zentrum für Europäische
Wirtschaftsforschung GmbH

Series Editor

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ISBN 978-3-7908-2051-5

e-ISBN 978-3-7908-2052-2

DOI 10.1007/978-3-7908-2052-2

Library of Congress Control Number: 2008922731

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Production: le-tex Jelonek, Schmidt & Vöckler GbR, Leipzig
Cover design: WMX Design GmbH, Heidelberg

Printed on acid-free paper

9 8 7 6 5 4 3 2 1

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Preface

1. In its Annual Report 2003/2004, the German Council of Economic Experts launched a dual income tax as an option for a fundamental tax reform in Germany. In February 2005, the Federal Minister of Finance, Hans Eichel, and the Federal Minister of Economics and Labour, Wolfgang Clement, appointed the Council to prepare a detailed report on the economic effects of a business tax reform, with special emphasis on a dual income tax. With regard to the latter, conceptual problems of tax law and of tax administration were to be addressed as well as possible transitional problems when implementing a dual income tax.

2. The commissioned report was completed in April 2006 as a joint project of the German Council of Economic Experts (SVR), the Max Planck Institute for Intellectual Property, Competition and Tax Law (MPI), Munich, and the Centre for European Economic Research (ZEW), Mannheim. Responsibility for preparation of this study and primary work on this project were lying with

- Wolfgang Wiegard for the German Council of Economic Experts,
- Wolfgang Schön for the Max Planck Institute,
- Ulrich Schreiber and Christoph Spengel for the Centre for European Economic Research.

In the course of work many persons helped to prepare this report. An especially important role was played by Ulli Konrad (MPI) who contributed to the project by designing and formulating the draft for a new income tax law, by preparing drafts of parts of this report and by translating sections of the Norwegian tax committee's report (2003) from Norwegian into German. In addition, we are extremely grateful to Martin Finkenzeller, Michael Grünewald, Michael Overesch and Timo Reister (all ZEW) for their excellent help in the quantitative parts of this project.

3. We have had comments from and discussions with the following persons and institutions:

- German Federal Ministry of Finance,
- Friedrich Brusck and Matthias Schenk (Hessian Ministry of Finance),
- Dr. Jürgen Haun and Professor Michael Schaden (Ernst & Young AG),
- Professor Peter Birch Sørensen, University of Copenhagen,
- Professor Frederik Zimmer, University of Oslo,
- American Chamber of Commerce,
- Heads of Tax Departments of DAX-30 companies.

We express our gratitude for their valuable advice and encouragement.

4. The German Federal Ministry of Finance provided calculations of the expected tax revenue effects of introducing a dual income tax. Donia Maria Radulescu, ifo institute, Munich, and Michael Stimmelmayer, Centre for Economic Studies, University of Munich, estimated the effects of reforming capital income taxes on key macro-economic variables, such as GDP, employment and welfare, using their dynamic numerical equilibrium model ifoMOD, developed with the help of Professor Christian Keuschnigg, University of St. Gallen. We gratefully acknowledge their support.

5. As always, the administrative and scientific staff of the German Council of Economic Experts provided competent comments and technical help in preparing the German version of the report. Our special thanks go to Caroline Essig, Dr. Katrin Forster, Wolfgang Glöckler, Birgit Hein, Klaus-Peter Klein, Dr. Stephan Kohns, Uwe Krüger, Dr. Hannes Schellhorn, Volker Schmitt, Hans-Jürgen Schwab and Beate Zanni.

6. This book presents a reduced English version of the original report. The English version does not contain various details of German tax law, the draft for a new tax law necessary to implement a dual income tax in Germany as well as several detailed quantitative analyses on the comparative company tax burdens of a dual income tax as proposed here. Readers who are interested in all of these details are referred to the full German version of the report “Reform der Einkommens- und Unternehmensbesteuerung durch die Duale Einkommensteuer“ (Federal Ministry of Finance, 2006; also available at www.sachverstaendigenrat.org).

7. In preparing the English version of the report, Andrew Fenner provided a first draft of the translation and reviewed the final version. This was hard work, and he is due special recognition for his professional expertise. Ulli Konrad (MPI) and Timo Reister (ZEW) were extremely helpful in preparing and editing the English version. With admirable efforts and technical skills, the administrative staff of the German Council of Economic Experts prepared the final manuscript for publication. We express our gratitude to Wolfgang Glöckler, Birgit Hein, Uwe Krüger, Volker Schmitt, Hans-Jürgen Schwab and Sabrina Welter.

8. Finally, we acknowledge the generous financial support from Ernst & Young Foundation, enabling us to conduct the English translation and the publication of this report.

9. It is, of course, to be understood that none of the persons who have helped us is responsible neither for the views expressed in this report nor for any remaining errors and deficiencies.

Wiesbaden, August 2007

Bert Rürup and Wolfgang Wiegard (German Council of Economic Experts)

Wolfgang Schön (Max Planck Institute for Intellectual Property, Competition and Tax Law)

Ulrich Schreiber and *Christoph Spengel* (Centre for European Economic Research)

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1 Dual Income Tax: Supporting Arguments and Design – An Overview

1.1 In Support of Dual Income Tax

1.1.1 Objectives and Constraints for Reforming Business Taxes

1. In November 2005, Germany's major political parties, the CDU, CSU and SPD issued a coalition statement, setting out the guidelines for the Federal Government's policy under Chancellor Merkel. On 'reforming business taxes', this statement reads as follows:

Germany must be able to hold its own in competing internationally on tax into the future. In this legislature period, until 01.01.2008, we will, therefore, continue to develop business tax laws thoroughly, implementing tax rates that are competitive internationally. As well as corporations, these reforms must also include transparent entities, as these account for more than 80% of all German businesses. In particular, we will be guided by the following aims:

- Making Germany more competitive internationally and viable within Europe
- Improving neutrality in terms of legal form and financial decisions as far as possible
- Limiting the room for creative accounting
- Improving planning certainty for businesses and the public budgets
- Safeguarding Germany's tax base in the long term.

We will make a basic decision between comprehensive and dual income taxation. In this legislative period, we will reform the taxation of capital gains and private profits on disposals (Coalition agreement, 2005).

2. As is well known and documented in detail,¹ the way Germany taxes business at present fails to achieve these objectives. Germany is not competitive in international tax terms, because our tax rates and effective tax burdens on business profits are amongst the highest in Europe. This encourages businesses to relocate

¹ See German Council of Economic Experts (2001: section 372 pp.; 2003: section 518 pp.; 2004: section 759 pp.; 2005: section 391 pp.).

production and/or profits to lower-taxed countries abroad. Which means in turn that fewer and fewer groups pay tax in Germany. Our current system of business taxation also distorts matters when businesses decide how to raise finance and what legal form those businesses should take. With corporations, financing investment from internal funds is generally treated more favourably in tax terms than debt and equity finance. With transparent entities, the situation is slightly in favour of debt while the transparency principle means there are no differences in taxation between profits retained and profits taken. If finance is raised equally out of retained earnings, new share issues and debt, the tax system favours partnerships over corporations if the top rate of personal income tax applies, but treats them much worse if the partners are on zero tax rate. None of this makes any sense from an economic point of view. It distorts competition and affects the amount of capital that is employed as well as its efficient allocation between sectors of production. As a consequence, production inefficiencies and income losses will result, and the complexity of the tax system will increase.

Therefore, the reform of business taxes is mainly aimed at making Germany more attractive to international investment and improving the neutrality of the tax system.

Distribution objectives come into play when reforming business taxes as soon as we are dealing with shareholders or partners individually. If we keep partnerships transparent for tax purposes, this is automatically the case, as there is no distinction between the business itself and those involved in it from a tax standpoint.

3. If reforming business taxation is to work, there are other requirements to meet, which can be formulated as constraints on reforms. One essential here is that they have to be compatible with European law. They have to comply with the fundamental freedoms of the EC Treaty, the freedom of establishment and free movement of capital in particular. One of the ‘softer’ constraints here is the need to limit loss of tax revenues, to safeguard Germany’s tax base. This demand can only reasonably be applied to the revenue effects involved with the specific rate and system characteristics of a given set of tax reform proposals. A tax system which satisfies the neutrality objective automatically limits room to maneuver: Because decision-neutral taxation means the way business is taxed has no effect on when businesses come to decide how to finance their investments or decide what legal form their business should take. That is to say, they would take the same decisions, whether they take taxes into account or not. So they need not spend time planning their tax matters in view of avoiding taxation. Now, there is no way of achieving complete neutrality with respect to financing decisions and choice of legal form. There will always be some space to maneuver. When reforming business taxation, it is, therefore, also advisable to demand that space to be limited.

4. *Conflicts of objectives* may arise, especially if a direct progressive income tax rate is considered necessary to achieve distribution objectives. This inevitably undermines the aim of being neutral in terms of finance and legal form. The more external reform constraints have to be taken into consideration and the

more stringent they are, the harder it becomes to achieve the aims of reforming the business tax system. For example, limiting loss of tax revenues comes directly into conflict with the aim of making Germany more attractive as a place to do business.

What stands out most about the present proposals to reform tax on business is that these emphasise potential conflicts between the aims of tax policy differently or are based on differing reform constraints. Comparing tax reform strategies should, therefore, be based on the reform elements which make up individual proposals. Reforming tax accounting, for example, is irrelevant when choosing between individual models, and may, therefore, be ignored here because this objective is compatible with all of the existing reform proposals.

5. The vast majority of foreign investment is made by corporations. When multinational groups decide where they should be based and how they should invest, their decisions are not, as a general rule, governed by how their shareholders are subject to personal income taxes. Firstly, the ‘marginal’ investor who is relevant to decisions by publicly-quoted corporations is often unknown or does not pay tax; secondly, the move away from imputation systems which is apparent internationally has decoupled taxation at corporate and at shareholder level. We may, therefore, assume that it is the rate of corporation tax or, more generally, taxation at corporate level which decides over how attractive individual locations are to international corporations. The assumption here is that the aim should be a *25% rate at corporate level* if the objective is to *make a location more attractive*. This target variable also serves as the basis for most of the tax reforms proposals which are currently under discussion in Germany. This 25% tax rate should include the solidarity surcharge of currently 5.50% and either trade tax or the tax burden on business profits resulting from reorganising local government finances. A higher tax rate could also be used to limit loss of tax revenues, but this would make Germany less attractive as a place to do business.

6. Making Germany more attractive as a business location could be done by reducing the tax rates on corporations. If done in isolation, however, this would merely exacerbate the already existing distortions and tax differences in the field of business tax. These tax differences relate to the taxation of retained and distributed profits on corporations, taxes on interest resulting from assignment of debt compared to taxes on equity capital and, lastly, taxes on profits by transparent entities (sole traders and partnerships) as opposed to corporations. Such differences distort how businesses choose to finance themselves and what legal forms they choose to take and are, therefore, undesirable in principle. They lead to efficiency losses, which are reflected in avoidable losses in production and income. While trying to make Germany more attractive as a place to do business, we must, therefore, at the same time improve the *neutrality properties of business taxes* with respect to financing and investment decisions and the choice of legal form.

7. The objectives of business tax reforms making Germany more attractive as a place to do business and ensuring neutrality of the tax system will be severely

limited from the outset as long as *trade tax* remains in place. In a rational business tax system, there is no place for trade tax in the currently existing form. It should be abolished and replaced with a local government surcharge system to income and corporation tax. The reorganisation of local government finances as proposed by the *Stiftung Marktwirtschaft* (2006) is a potential solution here.

Although the shortcomings of trade tax are well known and have been explained often enough, it is highly unlikely local government taxes can be fundamentally reformed by 2008. Revenue from trade tax is soaring and will be higher in 2006 than ever before. For that reason alone, local authorities and their representatives can hardly be expected to agree upon abolishing trade tax and replacing it with a local government surcharge system in the foreseeable future.

However essential reorganising local government finances may be, reforming corporate taxes in 2008 must not be allowed to fail because trade tax is retained. The dual income tax can also be realised even if trade tax remains.

1.1.2 Reform Options: Comprehensive or Dual Income Tax?

1.1.2.1 Comprehensive Income Tax

8. One of the first basic decisions which has to be made when reforming business taxes is whether the tax policy ideal of a comprehensive income tax is to be retained or whether it should be abandoned. Comprehensive income tax means that the total income from all sources together is aggregated, and the resulting taxable income is subject to a single tax schedule.

When it comes to reforming business taxes, comprehensive income tax undeniably has advantages, especially if it is imposed at a *flat rate*, that is, a single marginal tax rate over a basic allowance, and income tax and corporation tax are integrated by using the same marginal tax rate for each.² The major advantages of a flat tax with integrated corporation tax as an option for reforming business taxes apply even if a comprehensive income tax is hardly feasible in its pure form.

9. A comprehensive income tax, combined with a *flat rate*, would result in a largely insolvable dilemma if the aims of corporate tax reforms are combined with those of limiting loss of tax revenue. Making the German tax system more competitive internationally calls for a tax rate of 25% (or thereabouts) for corporation tax and for income tax. At the same time, the basic allowance for income tax would have to be set high enough if excessively drastic redistribution effects are to be avoided. Using both – a lower corporate as well as marginal income tax rate and a higher basic allowance – would result in losing considerable tax revenues. If the aim is to avoid losing any more tax revenues than necessary, this cannot be

² See Scientific Advisory Committee of the German Federal Ministry of Finance (2004).

combined with making Germany more attractive as a place to do business and achieving a just and equitable distribution without considerably compromising.

10. In what follows below, we will assume that there is no chance of introducing a comprehensive income tax by way of a *flat tax* in Germany within the near future. Retaining a direct progressive income tax system in particular would make it impossible to achieve decision-neutral taxation in business without resorting to the imputation system for corporation and personal income taxes in the first place. But reintroducing the imputation system has no chance of realization at all. If we wish to achieve the objectives of business tax reforms as stated, we must say goodbye to the tax policy ideal of a comprehensive income tax.

1.1.2.2 Interest-Adjusted Income and Profits Tax

11. Interest-adjusted income and profits tax is another tax policy ideal: In addition to making Germany more attractive and achieving a neutrality of finance and legal form, it would also ensure inter-period neutrality in investment and consumption decisions. The constituent elements of this tax concept at corporate level consist of deducting imputed normal return on equity capital from taxable income (*allowance for corporate equity*) and, for individuals, in allowing them to claim relief on interest income and on dividends as well as on capital gains upon the disposal of shares at a standard statutory rate. Any profit shares in excess of that and any other income would then be subject to a *flat tax*. Such a tax system was applied in Croatia between 1994 and 2000; in Belgium the legislators introduced a rule making a standardised return on equity capital tax-exempt for corporations (although no dividends paid) in 2006.

This reform option has not figured in the German tax policy debate despite its attractive neutrality aspects. It is not an option for the business tax reforms in 2008 for a number of reasons. Following recent Belgian developments would be inadvisable, given the massive loss of revenue in terms of corporation tax this would involve.

1.1.2.3 Dual Income Tax Versions

12. If tax policy ideals are unachievable, pragmatic compromises are required. If we drop the idea of a comprehensive income tax, this automatically implies that we must move to a schedular tax, with different kinds of income and earnings being subject to different rates. As a special case of a schedular tax, dual income taxation distinguishes between two kinds of income, each with its own tax rates. As the different kinds of income to be separately taxed can be defined differently, there are a number of possible options for a dual income tax. In fact, most of the tax reform proposals being discussed at present are different embodiments of a dual income tax – even if that is not necessarily how the supporters of each proposal actually see them.

1.1.2.3.1 Final Withholding Tax on Interest Income and Tax on Imputed Return on Capital

13. *The final withholding tax* on interest income proposed by a number of institutions (and also on dividends and profits on the disposal of shares in corporations) is a first version of dual income tax. Here, interest income is subject to a proportional tax rate of, e.g., 25% while other taxable income is subject to progressive income tax rates. With regard to business taxes, introducing a final withholding tax in isolation would clearly be counter-productive, as it would make businesses less inclined to invest out of their own resources. To exemplify this: Let us assume the interest rate on bank deposit accounts is 6%. If the final withholding tax on interest income were 25%, this would give a return after tax of 4.5%. If investment financed out of equity capital were taxed at 50%, any actual investment would then have to yield a minimum return of 9% before taxes to be attractive to investors. Introducing final withholding tax on interest income would mean that businesses do not proceed with investment projects with returns before tax of 6% to 9%, which would have been profitable had the withholding tax not applied. It would also affect how businesses choose to finance real investment: It would shift the financing structure even more to the detriment of equity capital.

14. The drawbacks of a final withholding tax as stated could be avoided by incorporating it as part of a general reorganisation of capital income taxation with a single rate tax rate on imputed (normal) returns of capital. This approach is in line with the concept of a *tax on imputed return on capital* proposed by the *Hessian Ministry of Finance*.³ Under this concept, interest, dividends and private capital gains upon the disposal of shares would be taxed at a single final withholding tax of 17%. This tax rate is consistently applied to imputed return on working equity capital. This means business profits are divided into a normal rate of return on equity capital, typically 5%, and any profits beyond that return. Whereas imputed return on equity is subject to the capital tax rate of 17%, any further profits are taxed via normal income tax or corporation tax. One disadvantage with a tax on imputed return on capital as proposed by the Hessian Ministry of Finance is that it is not in total finance-neutral but has the advantage of being comparatively simple to implement.

1.1.2.3.2 The *Stiftung Marktwirtschaft*'s Uniform Business Tax Proposal

15. On January 30 2006, the *Stiftung Marktwirtschaft*'s 'tax code' committee presented its tax policy programme in three modules. Alongside a uniform business tax (module I), these include a four-tier solution for reorganising local government finance (module II) and a new income tax law (module III).⁴

The aims of a uniform business tax are stated as being largely neutral to the legal form of business and as reducing business taxes to a level which is internation-

³ See Hessian Ministry of Finance (2005).

⁴ See *Stiftung Marktwirtschaft* (2006).

ally competitive. The low tax rate is limited to profits retained within a business, and dividends and withdrawals are subject to top-up tax.

16. The main features of the uniform business tax are as follows: The parallel system of taxing partnerships transparently but taxing corporations and shareholders separately is abolished in principle. This is done by extending the corporation tax law to cover partnerships, making it a uniform business tax law. This business tax would then apply not only to corporations but also to trading partnerships, other business partnerships and to sole traders. Profits at business level would be subject to final tax, preferably 25% but not more than 30%. This includes the burden of the local government tax as proposed in module II. If partners take profits out of the corporation, they would be liable to pay top-up tax on part of the profits distributed as dividends or taken, so that the aggregate tax burden would be equal to the top income tax rate.

To avoid putting any additional burden on small and medium-sized enterprises by finally taxing them at corporation level, it is proposed that small businesses – that is, transparent entities whose profits do not ‘consistently’ exceed EUR 120,000 – will continue to be subject to income tax. There is a second special provision for ‘transparent withdrawals’. This provides that profits taken out from partnerships up to EUR 120,000 are deductible, provided they go directly to individuals involved in the business and do not result in the business incurring a loss. There is one other difference to the uniform business tax concept: There are some circumstances in which losses can be devolved from the business to the partners.

17. While the uniform business tax makes Germany more attractive in terms of tax rates and is more neutral with respect to choice of legal form than current legislation, it is not finance-neutral by any means. Self-financing, debt and fresh equity finance are taxed quite differently. What is less important, on the other hand, is whether we include the *Stiftung Marktwirtschaft* proposals under the concept of a dual tax system. It is a dual income tax in that sense that income which businesses earn and retain is taxed differently from income attributed to individuals.

1.1.2.3.3 The Dual Income Tax of the German Council of Economic Experts, the Max Planck Institute and the Centre for European Economic Research (SVR/MPI/ZEW)

18. This section looks at the *dual income tax* as advanced by SVR/MPI/ZEW in outline and the subsequent sections of this opinion in great detail. The model the German Council of Economic Experts presented in 2003⁵ has been considerably modified in the light of draft tax reforms which Norway drew up and partially implemented from 2005 onwards⁶ in order to avoid or limit space to maneuver.

⁵ See German Council of Economic Experts (2003: section 584 pp.).

⁶ See St.meld.nr.[white paper] 29 (2003-2004) based on the tax committee’s report Skatteutvalget (2003); see mainly Sørensen (2005) or Gjems-Onstad (2005).

The main features of this dual income tax system may be defined as follows: a parallel system of the principle of transparency when taxing partnerships and the principle of separation when taxing corporations remains. All capital income is, in principle, subject to a proportional tax of 25%. As well as interest, capital income also includes a share of the profits from commercial and self-employed activity, income from agriculture and forestry and letting and leasing, representing a standard return on the equity capital employed. Any profits in excess of this and any other income are subject to income tax at progressive rates. Dual income tax, therefore, involves a splitting of profits at business level into normal and above-normal profits. Any dividends and capital gains upon the disposal of shares over and above the standard rate of return on equity capital are also included under capital income tax.

19. Dual income tax has a number of *advantages*. It would make Germany much more attractive for international investment by reducing tax rates on corporations. Dual income tax also guarantees a high degree of decision neutrality. It ensures finance neutrality for ‘marginal investment’ which earns precisely the capital market rate of return. As this happens irrespective of what legal form of business is used, it is also neutral as to choice of legal form. By extending withholding taxation at source to include interest on debt, dividends and capital gains, it helps reducing tax enforcement costs here. It also minimises tax planning costs, as its improved neutrality reduces the opportunities for avoiding it. Taxing capital income and other income differently reflects the fact that capital as a production factor is much more mobile internationally than other income and, hence, can avoid national taxation much more easily. For reasons of economic efficiency, capital income should, therefore, be treated much more gently in tax terms if loss of tax revenue is to be avoided. Dual income tax also offers benefits, given that corporate taxes are on the verge of being harmonised at European level. Taxing capital income and other income separately would leave Member States large areas of tax autonomy and, hence, more room to maneuver in their national tax redistribution policies.

20. Dual income tax borrows and pragmatically combines the main features of both ideal tax systems as outlined above. It recognises the advantages of a *flat tax* but restricts a proportional tax rate to internationally mobile capital income. It achieves decision neutrality by using a standard rate of return on equity capital although it applies the moderated capital income tax rate here and this is not tax-exempt as with interest-adjusted profits tax. Both safeguard Germany’s tax base in the long term. In the long term, dual income tax could be converted to one of the two tax policy ideals. That would mean either making other income subject to the single capital income tax rate – the result would be a comprehensive income tax with a general *flat tax*; alternatively, the capital income tax rate could be reduced to zero, which would result in the interest-adjusted income and profits tax model. Dual income tax is, therefore, a pragmatic compromise between two otherwise incompatible ideal taxation models.

21. Dual income tax has many advantages, but it also has some *drawbacks*. Any schedular tax inherently encourages taxpayers to convert income taxed at higher rates to income taxed at lower ones. As a specific drawback of a dual income tax system, it may be justifiably argued that it would imply increased recording requirements for banks and those drawing capital income. These are required to ensure finance neutrality, whatever the legal form of business; they are, so to speak, the price for wide-ranging decision-making neutrality. On the other hand, it reduces the compliance and welfare costs of taxation which arise from tax planning activities ('tax planning costs') and from taxpayers trying to avoid tax ('excess burden' of taxation).⁷

1.1.3 On the Criticisms of Dual Income Tax

22. Dual income tax is often criticised in tax policy debates in Germany by politicians, economists and lawyers. Most of this criticism misses the point either because it looks at ideas which the (modified) dual income tax as presented here does not aim to achieve in the first place or because it ignores what requirements apply to dual income tax and what effects it actually has. Finally, ideological prejudices are often aired whose viability may justifiably be doubted.

23. All this criticism refers to the feature that dual income tax tends to tax labour income more heavily than capital income. This is seen as contrary to the so-called "ability-to-pay" principle of taxation, even to social justice as a whole. While it is true that, under dual income tax, the tax rate on capital income is lower than the top rate on labour income, there is no reason why this has to be the case with average tax burden on labour and capital income. Be that as it may, the critics are missing the point of the tax reforms proposed here. These reforms are about making Germany more attractive to business: For both German and foreign investors, it must be worthwhile once again to earn income and have it taxed in Germany. The more is invested, the more labour productivity increases and with it the real wages of those employed. So dual income tax would also benefit employees in Germany. Conversely, taxing capital income, which is internationally mobile, at high rates would do employees no good at all because the tax burden on capital would tend to be shifted to labour by paying employees less. In fact, dual income tax emphasises the efficiency effects of tax reforms. It aims at increasing the size of the 'cake' to be distributed, so the workers' share of that cake becomes larger as well. Dual income tax fits in seamlessly with a policy which focusses on growth and prosperity.

24. Dual income tax is based on the realisation that capital is mobile and, thus, it is easier to avoid the taxation of income from capital in any one country than the taxation of income from human labour – either legally by relocating real investment abroad or illegally by concealing portfolio income. It is often said that

⁷ See German Council of Economic Experts (2005: section 365 pp.).

‘human capital’ is also mobile, so there is no way any tax reform based on the ‘mobility’ of production factors could effectively discriminate between capital and labour. This argument falls short and fails to recognise tax and economic reality. Insofar as there is any sign of a ‘brain drain’ of qualified staff in Germany, this is only due to a minor extent to wage levels in Germany, still less to tax levels here. It is not lower tax rates young scientists and entrepreneurs are looking for abroad but attractive working conditions for demanding jobs. So, if there is a ‘tax competition’ for human capital in marked contrast to that for finance capital, it is rather limited. There may be some special rules for expatriates, but this does nothing to alter the fact that Germany is well-placed and competitive on tax levels for skilled labour (self-employed or otherwise) both in Europe and globally.⁸ There is, quite simply, no reason to reduce labour income taxation similar to those caused by the international pressure to conform when it comes to capital income.

25. As for designing a dual income tax system in more detail, one frequent criticism is that it is impossible to make a meaningful distinction between capital income and labour income in cases of owner-managers in sole proprietorships, partnerships and corporations with active owners. In particular, it is said to be impossible to determine a ‘reasonable entrepreneurial reward’ which could serve as a standard for labour income of ‘active’ owners. However, such distinction between capital and labour income is necessary under a dual income tax. If capital income is taxed lower than labour income, active owners have an incentive to transform management salaries into lower-taxed capital income. This criticism particularly stems from the tax models the Scandinavian countries Sweden, Finland and Norway have used in the past.

The model proposed here offers an improved approach which avoids the mistakes of previous approaches. In doing so, it follows practical experience and new draft legislation from Scandinavia. This updated approach aims to subject returns on capital – whether it be real or finance capital, equity capital or debt – to a single low rate of taxation. For partnerships this is an enormous simplification over past models: All that is needed is to make a standardised return on equity capital subject to the same favourable tax rate as for corporations. This rate of return is aligned with prevailing market debt interest rates and, thus, makes the system largely finance-neutral. Any debate about what a ‘reasonable’ director’s salary would be becomes completely superfluous. It also disarms the conventional arm’s length comparison by way of hidden profit distribution, first because paying active owners too much would immediately cause higher taxes, and second because paying them too little would result in both corporation and shareholders being taxed as well as bringing the tax back up to where it would have been. Any attempt to turn high-taxed labour income into low-taxed capital income would not be successful when objective variables (costs of acquiring corporation shares, partnership equity capital, statutory standard rate of return) could be used to distinguish between favourably treated return on capital and income taxed at progressive rates.

⁸ See PwC & ZEW (2005).

26. Finally, the idea that dual income tax favours corporations with healthy levels of equity capital is quite wrong. Insofar as businesses are largely financed by debt, this opinion suggests that it would imply more equal treatment in reality (more than under the law as it stands) because both debt interest and standard return on equity capital would be taxed at the same rate. Where businesses need little capital – by the nature of what they do, especially with service corporations –, there is no distortion either because such businesses are not usually competing with capital-intensive ones: Lawyers and management consultants do not normally compete with steel mills or wholesalers.

27. One school of thought argues that, comparing tax systems internationally, there is in fact no reason for far-reaching business tax reforms, which include partnerships, as tax levels for partnerships in Germany are not much more than for those for comparable entities in law abroad. But this criticism misses the point on three counts. The first point to note is that large areas of business, which in Germany are traditionally carried on as transparent entities, are operated as corporations abroad and as such are subject to particularly favourable tax rules. German transparent entities are, therefore, competing with foreign corporations and must not be disadvantaged in this competitive situation. Secondly, as far as German business is concerned, it should be noted that favouring corporations alone would distort matters when deciding what legal form of business to use. Lastly, we often read that dual income tax would favour partnerships which, while they have assets, generate little or no current income (bonds, real estate and land). That would only be the case if low-return assets could be parked in partnerships at will, and thus, actual operating income could benefit from the standard return on those assets. The proposals presented here include precautions to ensure that only the standard return on actual working capital is favoured. This does not, of course, prevent other assets (financial assets in particular) enjoying low tax rates on the actual earnings they generate, but this is the consequence of a tax system being finance-neutral.

1.2 Principles of Dual Income Tax

28. The characteristic feature of any schedular tax is that different kinds of income or earnings are subject to different rates of tax. With dual income tax as proposed here, the so-called *earnings income* is treated differently from *capital income* for tax purposes. Both kinds of income are derived from the individual sources of income via an intermediate step. Dual income tax divides income into four categories. How these are defined and how they differ from the categories of income under current law is explained in section 40 onwards, as is the transition to earnings and capital income.

29. In principle, taxable earnings income is taxed at the linear progressive tax schedule (T 2005) currently used in Germany. Taxable capital income, on the oth-

er hand, is subject to a moderated tax rate of 25%. In fact, taxing capital income is integrated in T 2005 by way of an additional proportional band. This ensures that capital income is not treated worse for tax purposes than is the case at present but is generally better off, in fact. The integration in T 2005 applies to all earnings qualifying as capital income unless they were subject to final withholding tax. The precise tax schedule is outlined in section 47 pp.

30. Dual income tax will remain as close to current German tax law as possible. It involves no changes in corporation tax law apart from a change in the rate of corporation tax. Changes in income tax law will be limited to what is absolutely necessary; but some new definitions will have to be added to tax law.

1.2.1 Basic Definitions, Types of Income and Tax Rates

1.2.1.1 Standard Rate of Return, Return on Equity Capital and Return Allowance

31. The fundamental principle of dual income tax is to subject returns on capital invested to more favourable tax rates, irrespective of what kinds of organization are involved and how they finance themselves. The first step required here is to combine a number of definitions in terms of return on capital.

32. As with current tax law, under a dual income tax system, the *return on debt* also comes under capital income. The basic assumption, therefore, is that the return on debt will be subject to tax at the lower rate of dual income tax. From a tax standpoint, however, it should be immaterial whether lenders provide debt or equity capital or whether additional investment is financed externally or from within implying that all income which requires capital to be employed must be included as capital income on a par with return on debt. Income obtained from employing equity capital and corresponding to return on debt will be referred to as *return on equity capital*. Return on equity capital is obtained by multiplying a *standard rate of return* based on interest on debt by a *return base*.

33. As this maintains the twin-track approach of transparency in taxing partnerships and taxing corporations and shareholders separately when determining the return base and taxing returns on equity capital, we have to distinguish between using equity capital for the purpose of business activities which are subject to income tax and the corporation which is subject to corporation tax. With partnerships the return base is principally⁹ equal to the business's equity capital for tax purposes, including any capital shown in supplementary and special accounts.

⁹ Technically, however, the return base for partnerships is calculated using a different method (section 56 pp.).

Where equity capital is provided to corporations, the return base is determined via the costs of acquiring the holding as far as the shareholders are concerned.

Multiplying the return base by the standard rate of return gives the return on equity capital (Fig. 1). The *return allowance* for shareholders in corporations is obtained by multiplying the return base by the standard rate of return after tax. Taxable capital income, then, consists of those dividends and capital gains in excess of the return allowance in question. The relationship between return on equity capital and return allowance is explained in more detail in section 52 onwards.

Fig. 1. Dual income tax: Determination of return on equity capital for tax purposes



34. The return base as well as the choice of the *standard rate of return* determine the return on equity capital and, hence, how much capital income is eligible for the reduced rate of tax. In a world of certainty with a single proportional rate of tax and a perfect capital market, choosing the standard rate of return would be simple: It would be equal to the capital market interest rate and, hence, the return on alternative investments for the equity capital employed. Investment financed from within, which earns precisely the capital market rate (and hence the standard rate of return) is known as the *marginal investment*. Any investments which earn a return over the capital market rate are *profitable* and are preferred to investing in the capital markets. With an interest-adjusted profits tax as well as interest on debt, the standard return on equity capital obtained via the standard rate of return would also be deducted from the tax base: So debt and equity capital would be identically treated in tax terms at business level. Those obtaining the capital returns would not be liable to tax. The interest-adjusted profits tax would then be based on pure profits or ‘economic rents’. With dual income tax, return on equity capital is not deducted from the tax base. Treating debt and equity capital equally in tax terms is achieved by equalising the tax burden on the recipient’s interest income and the standard return on equity capital. Pure profits, on the other hand, would be subject to higher tax.

35. Capital markets are not perfect, of course, and there is no certainty that investment will be successful. If debt and equity capital are to be treated equally,

the standard rate of return should be guided by the nominal rate of interest on long-term debt. The return on capital, which is favourably treated for tax purposes, is calculated as the return on the equity capital employed. This means setting a standard rate of return for tax purposes. Ensuring neutrality of finance towards taking up debt, this standard rate of return should be aimed at the long-term interest rate on borrowings. This could be based on an index of European corporate bonds over a two- or three-year average.

36. A risk surcharge can be added to this although this cannot be justified by simply assuming that employing equity capital is subject to an increased risk. Dual income tax means tax savings for capital income compared with earnings income. These tax savings can be achieved by risk-free investments in the capital market and must likewise arise with risky investments, if the latter are not to be ‘over-favoured’ in tax terms. When choosing a standard rate of return, the yardstick must, therefore, be whether the tax savings aimed at are certain even if the earnings on the investment itself are not.¹⁰ In view of this, adding a risk surcharge to the long-term interest rate on debt can only be justified if a number of restrictions in law are imposed on using return allowances or if losses which can be deducted for tax purposes are limited. Such restrictions equally prevent investors rating the tax effects of losses and profits expected in future, which works against riskier investments. Precisely how much any surcharge justified on this basis should be is hard to say in any case.

37. In estimating the interest rates on long-term debt for the purposes of this opinion, we use the rates of return calculated by Merrill Lynch on European corporate bonds in debtor class BBB. Fig. 2 shows how this has progressed since 2002. Using a two-year average gives a value of 4.5%, a three-year average 4.8%. Including a surcharge justified as above gives a standard rate of return of 6%.

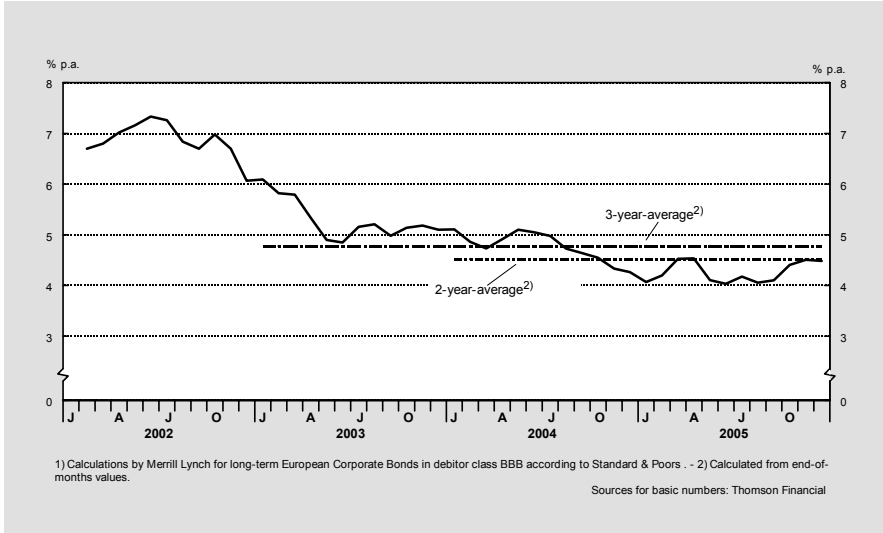
38. Using a standard rate of return of 6% is in line with legislative assumptions as laid down in other regulations, such as setting the interest rate for pension provisions at 6% (§ 6a para. 3 S. 3 ITA) or interest in tax proceedings (§ 238 para. 1 GTC). And it is not far removed from the guideline rate of 5.5% as used in valuation tax law for many decades (§ 12 para. 3 cl. 2 VTA), which was recently adopted in tax accounting law (§ 6 para. 1 no. 3 cl. 1 and no. 3a lit. e cl. 1 ITA).

39. The standard rate of return for tax purposes is set by the legislators reviewing it every third year. In setting the rate, the legislators should be guided by an index to be published by the Deutsche Bundesbank, e.g., of yields on long-term corporate bonds plus a surcharge. Using a three-year period gives taxpayers a reliable basis on which to plan. While setting the rate of return for tax purposes falls within the remit of democratically legitimised bodies in the course of federal legislation, the politicians must accept that this rate is *not an instrument for managing economic policy* but an integral component of dual income tax intended to ensure

¹⁰ See Fane (1987) and Schreiber (2005).

that finance via debt and finance out of equity capital continue to be treated largely equally in line with actual developments in the capital markets.

Fig. 2. Rate of return on corporate bonds

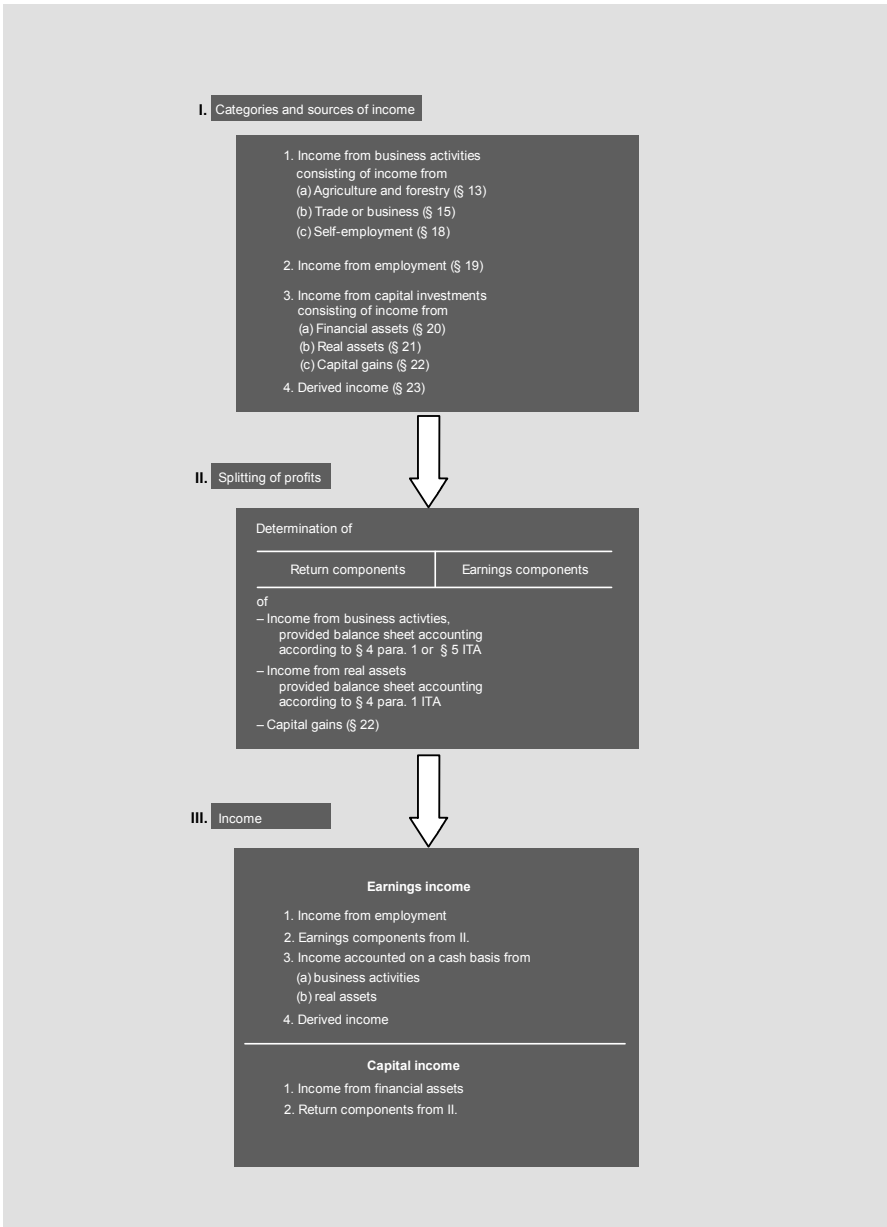


1.2.1.2 Types of Income and Taxable Income

40. Dual income tax distinguishes *four categories of income*, which break down, to some extent, into individual sources of income. Fig. 3 shows the categories of income for a dual income tax and shows how these types of income are aggregated to the two main categories of income: earnings income and capital income. It also cites the appropriate sections of a revised income tax law (ITA draft) although this is only available in the German version of this report ([www. sach-verstaendigenrat.org](http://www.sach-verstaendigenrat.org)).

41. As with current law, dual income tax divides income into income from agriculture and forestry, from trade or business and from self-employment, which are combined here to form *income from business activities*. This also includes income from disposing of a business. *Income from employment* remains unchanged. The third category of income is *income from capital investments*: This comprises income from financial assets, income from real assets and from capital gains. Income from financial assets is equivalent to the existing income from capital investments according to § 20 ITA with the generalised paragraph 1 no. 4 establishing a liability to tax for all forms of profit-based payments by corporations or partnerships. Existing income from letting and leasing is included in income from real assets, which also includes the tax liability for payments for use under the present § 24 para. 3 ITA: Therefore, the term ‘letting and leasing’ for this source of income no longer applies.

Fig. 3. Dual income tax: From sources of income to earnings income and capital income



42. Income from capital gains, on the one hand, extends the *tax on capital gains* under the current §§ 17 and 23 ITA by abolishing holding limits and shareholding threshold, but on the other hand restricts it to fixed assets which are in-

tended to generate income. This means owner-occupied properties are no longer subject to tax. Comprehensive changes are required to other income in § 22 ITA: Income from private disposals for the purposes of § 22 no. 2 ITA is subsumed in income from capital gains under § 22 ITA draft. Income from occasional licenses to use under no. 3 of the present § 22 ITA are included in income from real assets under § 21 ITA draft. Lastly, income from employment comes under § 22 no. 4 ITA (§ 19 para. 1 cl. 1 no. 3 ITA draft).

43. Income from recurrent drawings under the current § 22 no. 1 ITA and the payments listed in § 22 no. 5 ITA are classified as ‘derived income’ in § 23 ITA draft. These are cases of derived ability-to-pay where pension payments to third parties (interpersonal transfers) or expenditure to secure retirement pensions (intrapersonal transfers) as operating costs, recruitment costs or extraordinary costs reduce a taxpayer’s income and are taxable as an inflow to another person or at a later date.

44. As an intermediate step in the transition to taxable incomes, income from business activities is subjected to a *splitting of profits*. This also applies to income from real assets where the profits on such income have to be calculated by balance sheet accounting (§ 4 para. 1 ITA). These principles are also in effect for certain other sources of income.¹¹ Splitting these profits divides into profits from the return on equity capital described above (*return components*) and in profits in excess of that return on capital. This latter component of profits may (but do not need exclusively) derive from the labour contributed by a (co-)entrepreneur or self-employed person which is not rewarded otherwise: Thus, they should be taxed in the same way as income from employment. The profit components in excess of the return on equity capital may also be attributable to economic returns obtained by using specific business assets, unrewarded production factors (such as the public infrastructure) or a monopoly position in the segment concerned. From a macro-economic standpoint, there is no reason to subject such income to the reduced rate for capital income. The profit shares over and above the return on equity capital are termed *earnings components*.

45. In a final step, income is then divided into the two types which are characteristic of dual income tax, which are subject to different rates of tax in principle.

Earnings income includes

- income from employment,
- earnings components obtained by splitting of profits,
- income from business activities and from real assets where calculated via cash basis accounting, and

¹¹ This includes capital income from assets via hybrid financing of partnerships (e.g., profit-sharing loans) and profits on disposals of shares created by contributions and fixed assets used to obtain income from real assets and capital assets via hybrid financing of partnerships.

– derived income.

Capital income comprises

- income from financial assets, and
- return components obtained by splitting of profits.

46. Taxable earnings income and capital income are obtained by deducting losses, allowances and other amounts deductible from income.

1.2.1.3 Tax Schedule

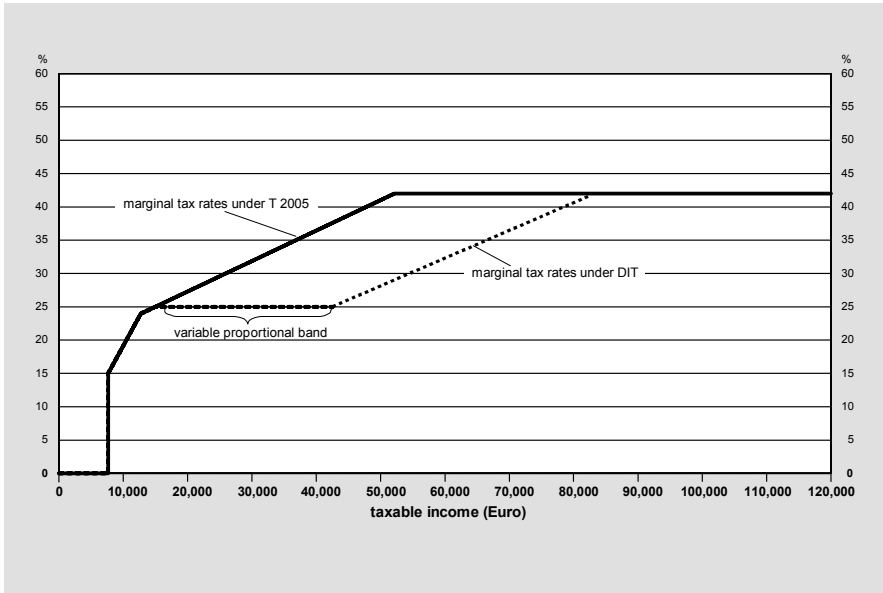
47. With dual income tax, in principle, taxable earnings income and capital income are subject to *separate tax schedules*: Earnings income is subject, as before, to progressive income tax (T 2005) under § 32 a ITA. Capital income, on the other hand, is taxed at a proportional rate of 25%. Interest on debt and capital income from dividends and capital gains upon the disposal of shares in corporations over the relevant return allowance are subject largely to an anonymous *final withholding tax* of 25%; but this would be combined with an *assessment option*, as it would otherwise leave taxpayers worse off than they are under the current income tax. The constitutional law requirements of the objective and subjective net principle must be satisfied as well. The tax position might also be worsened if income from business activities or real assets defined as return on equity capital were taxed at the reduced rate of 25%. This would put small and medium-sized partnerships in a worse tax position if they are subject to a lower rate of income tax on average at present.

48. To avoid this happening, taxation of capital income is included in T 2005 by way of an additional proportional band. Marginal tax rates are, then, subject to the rates as shown in Fig. 4. One point to note here is that the length of the additional proportional band depends on the level of individual capital income to be taxed. The solidarity surcharge is not included in the proportional rate band in Fig. 4 as it should actually be for reasons of comparability. If the assessment option is not exercised in respect of the capital income subject to final withholding tax, the income concerned is not included in the capital income assessed either.

49. This additional proportional band makes calculating individual tax liability more complicated in that respect that variable income thresholds imply that this can no longer be read off from general tax tables. On the other hand, the extended tax schedule only affects those who earn income from capital: First, they are partnerships and sole traders who produce balance sheet accounts for themselves or their owners, for whom calculating their tax liabilities at the modified rates should not involve any more problems than before. Second, they are those who earn interest income or dividends/capital gains and who have opted for the assessment option. In many cases, the financial institutions managing the assets will be able to handle the tax documentation and calculation workload required. Owners of unquoted corporation shares or partnerships and sole traders who produce balance sheet accounts will generally have access to an online tax computer or produce

their tax returns with the aid of a tax adviser or tax software, in which case calculating their tax liability does not involve any serious problems. Otherwise, extending the rate system to include a proportional band can only work in favour of the taxpayers concerned. Even if the modified tax schedule is perceived as more complicated, those affected will presumably be satisfied to put up with this.

Fig. 4. Dual income tax: Marginal rate schedule



50. Lastly, matters could be simplified quite considerably by replacing the linear progressive tax schedule, as is occasionally proposed, by a stepwise linear tax schedule with one stage having a marginal income tax rate of 25% (or of 23.70% and an additional 5.50% solidarity surcharge). All that needs to be done is to raise the upper income limit for this rate stage by the value of the return on equity capital.

1.2.2 Taxing Corporations and Partnerships

1.2.2.1 Trade Tax and Dual Income Tax

51. The aims of business tax reform – making Germany more attractive to business and ensuring decision-making neutrality – will be severely impeded from the start as long as *trade tax* remains. This opinion, therefore, supports proposals (including the *Stiftung Marktwirtschaft's* concept) aimed at replacing trade tax with a local income tax (citizen tax) and local business tax as a supplementary tax

on incomes of individuals and corporations or partnerships. On the other hand, it would not be sufficient simply to extend the scope of businesses which are subject to trade tax (towards a local business tax) without taxing individual taxpayers accordingly. However urgent reorganising local government finance may be, reforming business taxes in 2008 must not be allowed to fail by retaining trade tax. If trade tax remains, introducing dual income tax is still possible and advisable; but compromises would have to be made on achieving the aim of decision-making neutrality. The best way of achieving corporate form and decision-making neutrality if trade tax is retained would be to *net* it against income and corporation tax while, at the same time, abolishing it as a deduction as operating costs. In principle, the maximum set-off value should be equal to the rate of income or corporation tax, although it should also be limited to an average trade tax levy rate, say the federal average, to avoid incentives to abuse.

In what follows below, we assume that trade tax has been abolished: This will sharpen the focus on the neutrality aspects of dual income tax.

1.2.2.2 Taxing Corporations and Their Shareholders

52. Dual income tax does not involve any changes to current *corporation tax law*. The corporation tax rate is set to give a rate of 25% at corporation level. This already includes the solidarity surcharge and possible local corporate tax. To simplify matters, we will assume corporation tax is 25% in this introductory section.

Splitting of profits into return on equity capital, which is subject to a reduced tax rate, and profits shares over and above the return on equity capital, which are to be taxed at a higher rate, can be done at corporation or shareholder level. For a number of reasons, it proves to be both advantageous and necessary to make this division of profits at *shareholder level*. The changes of the tax law therewith involved affect *income tax*.

53. Those who hold shares in corporations draw earnings on equity capital either by way of dividends or as capital gains upon disposals of shares. The aim is, therefore, to divide dividends and capital gains into reduced-rate and standard rate equity capital gains. We will limit our analysis to looking at dividends here; the same rules apply to taxing capital gains.

Shareholders' equity capital income to be taxed at the reduced rate are calculated via the return on equity capital, which is obtained by multiplying the return base by the standard rate of return. The return base is based on the acquisition costs of the shares. Return on equity capital should effectively be subject to a tax burden which is equivalent to the moderated tax rate of 25%. Any equity capital income in excess of this can be taxed at a higher rate.

54. Dividends by corporations have already been subject to corporation tax at a rate of 25% by the time they reach shareholders. To ensure the return on equity capital is effectively taxed at 25%, the corporation tax already levied must be taken out of the return on capital accruing to shareholders. The product obtained by multiplying the return base by the standard rate of return reduced by the rate of

corporation tax is termed the (periodic) *return allowance*. Dividends up to the value of the return allowance then remain *tax-exempt* as far as shareholders are concerned. This ensures that this component of dividends is effectively taxed at 25%. Any dividends in excess of the return allowance count as income from capital investments. In fact, these are earnings income because they derive from returns over and above the return on equity capital. For simplifying tax collection, however, and to allow for the fact that corporation tax has already been deducted, they are included under capital income. This means that they are either subject to a final withholding tax of 25% or, if the assessment option is exercised, are included in the income tax assessment. If the final withholding tax applies, given that corporation tax has already been deducted at 25%, this means the *taxable* components of dividends and capital gains are effectively taxed at 43.75% [$100 (0.25 + 0.25 (1 - 0.25))$]. This is close to the top rate of income tax (42.00%) under T 2005 of 44.31% including solidarity surcharge of 5.50%.

Fig. 5. Return on equity capital and return allowance with immediate dividend distribution

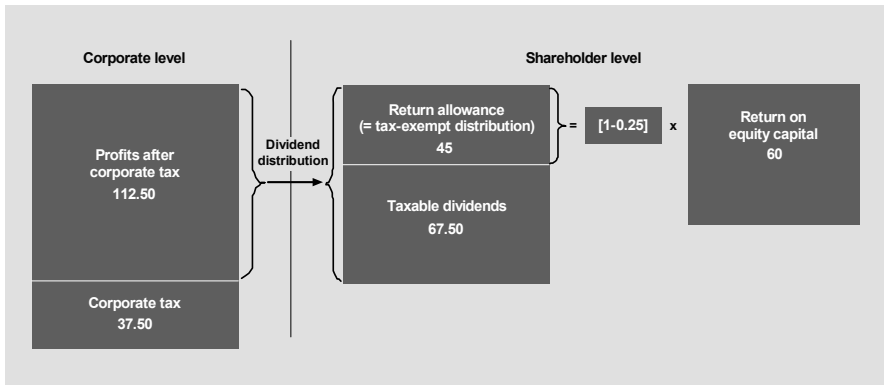


Fig. 5 shows the relationship between return on equity capital and return allowance if profits are distributed as dividends immediately. The figures used here are based on the circumstances in Example 1.

Example 1: As the year opens, a corporation is founded with an equity capital of 1,000 units, which corresponds to the costs of acquiring the shares. The overall return on capital is 15%, the standard rate of return for tax purposes is 6%. The corporation makes a profit before tax of 150 units. Corporation tax is 25%. In its first year, the corporation distributes all the profits made after corporation tax at 112.50 units. The return on equity capital calculated at the shareholder level is 60 [$0.06 * 1,000$], the return allowance is 45 [$(1 - 0.25) 60$]. Dividends up to the value of the return allowance remain tax-exempt, dividends in excess of that at 67.50 are taxable capital income, and are taxed at 25%. Net dividends in Year 1 are 95.62 units. Table 1 sets out a simplified method for calculating the tax liability.

Table 1. Dual income tax: Taxation of corporations and shareholders with immediate distribution of dividends

(1)	Equity capital (opening balance)	1,000	} Corporate level
(2)	Profit before tax ¹⁾ [0.15 * (1)]	150	
(3)	Corporation tax [0.25 * (2)]	37.50	
(4)	Profit after corporation tax [(2) - (3)]	112.50	
(5)	Dividends	112.50	
(6)	Equity capital (closing balance)	1,000	
(7)	Cost of acquiring holding (opening balance)	1,000	} Shareholder level
(8)	Return on equity capital [0.06 * (7)]	60	
(9)	Return allowance [(1 - 0.25) * (8)]	45	
(10)	Dividends before income tax of which:	112.50	
	(a) Tax-exempt [= (9)]	45	
	(b) Taxable [(10) - (10a)]	67.50	
(11)	Income tax [0.25 * (10b)]	16.88	
(12)	Dividends after income tax [(10) - (11)]	95.62	

1) Overall return on capital 15%.

Calculating the taxable capital income by shareholders of corporations is simple if the dividends (or capital gains) exceed the return allowance. If they do not, the way in which the return on equity capital is to be calculated has to be modified to ensure that it is still treated equally with earnings from providing debt. The modifications required involve, first, topping up the acquisition costs of those involved by the return allowances not taken in the preceding periods. This total then represents the return base for the accounting period concerned. Second, the return allowance obtained for each period must be topped up by the return allowances not taken in the preceding periods. The result is the allowance which can be set off for a period. Return allowances not taken in a period and, therefore, to be carried over to the next period arise if actual dividends are less than the return allowances which can be claimed in a period.

1.2.2.3 Taxing Transparent Entities (Partnerships and Sole Traders)

55. Taxing transparent entities continues to use the tried and tested principle of transparent taxation. If business tax is to be neutral in terms of legal form and financial decision-making, however, partnerships and sole traders must also be able to enjoy a reduced rate of tax on return on equity capital. This can be done by applying the standard rate of return described above to the business's equity capital. The return on equity capital (return component) obtained by multiplying the equity capital of the tax accounts (return base) by the standard rate of return counts as part of capital income and is taxed at the reduced rate of 25%.

56. Equity capital is defined as assets as per the tax accounts less liabilities. The part of profits exceeding the return on equity (earnings component) is subject

to the progressive T 2005.¹² This method of profit-splitting is known as the *net method*. Its drawback is that it offers room to maneuver. Alternatively, profits can be split via the *gross method*, which offers less room to maneuver and is, hence, to be preferred. This applies the standard rate of return not to the equity capital as per the accounts but to the assets.¹³ Subtracting interest on liabilities gives the return component to be taxed as capital income. The earnings component of profits, which is subject to tax as normal, is defined as the difference between profits before interest and the product of the standard rate of return and assets. Both the gross and net methods give identical results if interest rate on debt and standard rate of return are the same. If the standard rate of return is less than debt interest rate, the net method is more beneficial for tax purposes; if it is greater, the gross method is preferable. Table 2 illustrates how profits are split and tax applied when using the gross method.

Table 2. Dual income tax: Gross method for calculating profits in transparent entities

		Rate of interest	
		6%	8%
(1)	Assets	1,000	1,000
(a)	Debt	700	700
(b)	Equity	300	300
(2)	Profit before tax $[0.15 * (1)]$	150	150
(3)	Interest on debt $[\text{Rate of interest} * (1a)]$	42	56
(4)	Profit after interest $[(2) - (3)]$	108	94
(5)	Return component $[\{0.06 * (1)\} - (3)]$	18	4
(6)	Earnings component $[(2) - 0.06 * (1)]$	90	90
(7)	Income tax $[(7a) + (7b)]$	44.38	40.88
	on:		
(a)	Return component $[0.25 * (5)]$	4.50	1
(b)	Earnings component $[0.4431 * (6)]$	39.88	39.88
(8)	Profits after tax $[(4) - (7)]$	63.62	53.12
(9)	Taxes on interest income $[0.25 * (3)]$	10.50	14
(10)	Interest income after tax $[(3) - (9)]$	31.50	42
(11)	Total tax burden $[(7) + (9)]$	54.88	54.88
(12)	Total income after taxes $[(8) + (10)]$	95.12	95.12

Example 2: Let us assume a partnership with assets of 1,000 units, debt of 700 units and equity capital of 300 units. Let the overall return on capital be 15% and the standard rate of return 6%. The interest rate on debt is also assumed to be 6% or, in an alternative calculation, 8%. The return component is taxed at 25%, the earnings component at the top rate of income tax of 44.31% (including solidarity surcharge).

57. Table 2 shows how the gross method works. This method always gives the same overall tax burden, whatever interest rate on debt, as returns which are

¹² In the following presentation the integration of the reduced rate of capital income tax as an additional proportional band in T 2005, as described in section 47, is abstracted; instead, earnings income and capital income are subjected to separate tax schedules.

¹³ This needs to be corrected for certain financial assets, but these are ignored here.

taxed at the reduced rate are netted with a return component. So there is no advantage in agreeing excessive interest on debt: The tax saved by deducting the interest and the additional tax payable by the recipient precisely balance one another out. The gross method, thus, proves to be more resistant to manipulation and is, therefore, used when splitting profits.

1.2.3 Neutrality Aspects and Room to Maneuver

1.2.3.1 Finance Neutrality

58. Dual income tax ensures finance neutrality of taxation (Table 3). This means that total tax burden on capital employed in a business is unaffected by whether investment is financed via debt or equity capital. From the shareholder’s viewpoint, it makes no difference whether they finance a business with debt or equity capital.

Table 3. Dual income tax: Finance neutrality (Immediate dividend distribution)

	Equity capital high: 100% EC	Equity capital low: 10% EC	
(1) Equity capital (opening balance)	1,000	100	Corporate level
(2) Debt (opening balance)	-	900	
(3) Profit before interest and tax $[0.15 * \{(1) + (2)\}]$	150	150	
(4) Interest on debt $[0.06 * (2)]$	-	54	
(5) Profit after interest $[(3) - (4)]$	150	96	
(6) Corporation tax $[0.25 * (5)]$	37.50	24	
(7) Profit after interest and tax $[(5) - (6)]$	112.50	72	
(8) Dividends	112.50	72	
(9) Equity capital (closing balance)	1,000	100	
(10) Interest income $[(4)]$	-	54	Individual lender
(11) Income tax on interest $[0.25 * (4)]$	-	13.50	
(12) Interest income after tax $[(10) - (11)]$	-	40.50	
(13) Cost of acquiring holding (opening balance)	1,000	100	Individual shareholder
(14) Return on equity capital $[0.06 * (13)]$	60	6	
(15) Return allowance $[(1 - 0.25) * (14)]$	45	4.50	
(16) Dividends before income tax $[(8)]$	112.50	72	
of which:			
(a) Tax-exempt $[(15)]$	45	4.50	
(b) Taxable $[(16) - (16a)]$	67.50	67.50	
(17) Income tax on dividends $[0.25 * (16b)]$	16.88	16.88	
(18) Dividends after income tax $[(16) - (17)]$	95.62	55.12	
(19) Total tax burden $[(6) + (11) + (17)]$	54.38	54.38	Aggregate individual level
(20) Total income after tax $[(12) + (18)]$	95.62	95.62	

Example 3: This illustration looks at two corporations with different equity capital ratios which pay dividends after corporation tax in full. The first corporation, which is strong in terms of equity capital, uses equity capital alone while

the second, which is not, has an equity capital ratio of 10%. Both corporations are assumed to have an overall return on capital of 15%. The total tax burden consisting of corporation tax and income taxes on interest and dividends is, then, independent of the corporations' equity capital positions.

1.2.3.2 Legal Form Neutrality

59. The business tax reforms proposed here maintain the twin-track approach of taxing partnerships and sole traders by the transparency principle and taxing corporations and their shareholders by the separation principle. And they do not provide any option for partnerships and sole traders to be taxed as corporations. The same applies to a separate rate of income tax for profits not taken out of partnerships. Legal form neutrality cannot, then, be achieved completely; but it is guaranteed for so-called marginal investment in any case as return on equity capital is subject to a reduced rate of tax with partnerships and sole traders in any case. If profits are greater than the return on equity capital, legal form neutrality can be achieved if the tax burden on the profits shares of partnerships and sole traders exceeding the return to equity capital is 43.75%, i.e. close to the top rate of tax.

Table 4. Dual income tax: Sole traders

	Equity capital high: 100% EC	Equity capital low: 10% EC
(1) Equity capital	1,000	100
(2) Debt	-	900
(3) Profit before interest and tax $[0.15 * \{(1) + (2)\}]$	150	150
(4) Interest on debt $[0.06 * (2)]$	.	54
(5) Profit after interest $\{(3) - (4)\}$	150	96
(6) Return component $[0.06 * (1)]$	60	6
(7) Income tax $[(7a) + (7b)]$ on:	54.38	40.88
(a) Return component $[0.25 * (6)]$	15	1.50
(b) Earnings component $[0.4375 * \{(5) - (6)\}]$	39.38	39.38
(8) Profit after income tax $\{(5) - (7)\}$	95.62	55.12
(9) Tax on interest income $[0.25 * (4)]$	.	13.50
(10) Interest income after tax $\{(4) - (9)\}$	.	40.50
(11) Total tax burden $[(7) + (9)]$	54.38	54.38
(12) Total income after tax $[(8) + (10)]$	95.62	95.62

Example 4: This illustration assumes the businesses in example 3 are run as sole traders (Table 4). The interest rate on debt is taken as the standard rate of return. Profits up to the level of the return on equity capital as well as interest income by private lenders are taxed at 25%. In this example the profits the sole traders make in excess of the return on equity capital are subject to tax at 43.75%. In this case, the sole trader profits after income tax (line 8, Table 4) are equal to dividends after income tax (line 18, Table 3). This also applies to the total tax burden and total income (profits and interest income) after tax.

60. In example 4, the tax burden is independent of the legal form. This is because the tax burden on the sole trader's earnings component is equal to the total tax on the taxable dividends (including corporation tax already imposed). With corporations, retained profits are generally subject to the proportional rate of corporation tax of 25% while the nominal tax burden on dividends in excess of the return allowance is generally 43.75%. With partnerships, on the other hand, the progressive rate of income tax normally applies, irrespective of how profits are used, which increases or reduces the tax due, depending on how high the taxable income actually is. This means that profits by corporations until distribution may be taxed less than profits by partnerships, insofar as these are subject to an average income tax rate of more than 25%. This allows for the fact that corporations can have tax advantages over partnerships, as long as they do not distribute profits exceeding the (allowable) return allowance as dividends. These provisional advantages in terms of tax burden disappear, if we consider matters in the long term, as soon as profits are distributed as dividends. Even so, corporations enjoy liquidity advantages, even if only temporarily. On the other hand, if a corporation makes a loss, this cannot be offset against positive income of the shareholders (from management salaries, for example) whereas partnerships can do so in principle. Given these remaining differences in taxation, it is essential to provide businesses with the flexibility they need by enabling them to convert themselves without affecting their tax position. The present proposals for a dual income tax expressly provide for this possibility.

1.2.3.3 Room to Maneuver

61. If income from different sources is taxed differently, there will always be incentives to reclassify income taxed at higher rates as income taxed at lower rates. This is true for current income tax law, and it is also true for dual income tax. As income classified as capital income is subject to tax at 25% in principle, there is a difference in the top rate of income tax (including solidarity surcharge) of 19.31 percentage points (44.31% - 25%). One might think this offers considerable room to maneuver to reduce one's tax liability. This might take the form of increasing the return base so as to increase the return component taxed at reduced rate accordingly, or of agreeing unreasonable payments in contractual agreements between a corporation and its shareholders. On looking more closely, however, it emerges that the incentives to try creative tax accounting are limited and can be counteracted where they arise with conventional instruments, such as hidden profit distributions or constructive equity contributions.

62. The objection most frequently raised against dual income tax concerns the incentive to transfer highly taxed labour income from a corporation's managing shareholders to the corporation by agreeing on (unreasonably) low directors' remuneration. As this does not affect the return base for setting tax-free dividends, the tax savings to be made here are low (Table 5).

Table 5. Dual income tax: Room to maneuver through agreeing payments to director-shareholders

	Low salary	High salary
(1) Director's salary	100	190
(2) Profit before tax	150	60
(3) Corporation tax [0.25 * (2)]	37.50	15
(4) Dividends	112.50	45
(5) Income tax on salary [0.4431 * (1)]	44.31	84.19
(6) Salary after income tax [(1) - (5)]	55.69	105.81
(7) Cost of acquiring holding	1,000	1,000
(8) Return allowance [0.045 * (7)]	45	45
(9) Dividends before income tax of which:	112.50	45
(a) Tax-exempt [= (8)]	45	45
(b) Taxable [(9) - (8)]	67.50	.
(10) Income tax on dividends [0.25 * (9b)]	16.88	.
(11) Dividends after income tax [(9) - (10)]	95.62	45
(12) Total tax burden [(3) + (5) + (10)]	98.69	99.19
(13) Total income after tax [(6) + (11)]	151.31	150.81

Example 5: We have a corporation which makes a profit before tax and payments to directors of 250 units and distributes all its profits after corporation tax as dividends. This calculation diagram is shown in shortened form. If it agrees to pay a low remuneration to its directors, this increases the taxable dividends: As these are effectively taxed at 43.75%, the possible tax savings per reallocated euro are 0.0056 (0.4431 - 0.4375), i.e. a total of 0.5 (90 * 0.0056).

1.3 Quantitative Analysis

63. Reforming personal income and corporate tax via dual income tax aims at making Germany more attractive to business and at achieving decision-making neutrality. Making Germany more attractive from a tax standpoint will encourage investors to invest in Germany rather than elsewhere. Improving decision-neutrality of the tax system will help to use capital more efficiently. Increasing investment and allocating capital more efficiently will, in turn, increase employment and improve the conditions for growth.

This section looks at some of the quantitative effects of dual income tax. The calculations focus on the investment effects caused by the tax reforms and the effects the reforms are expected to have on tax revenues. However, with the data available it is impossible to identify the redistribution effects of the tax reforms.

64. When international investors decide where to invest, from a tax standpoint, this comes down mainly to what the *effective average tax burden* on profits is. This cause and effect relationship is well documented both theoretically and

empirically. The higher the effective average tax burden is in any one location, the less attractive that location is to international investors. Empirical studies have shown that, if Germany increases its average tax rates by one percentage point, this makes it one percentage point less likely that a US corporation will settle in Germany and not somewhere else in Europe.¹⁴ Our calculations with different model approaches indicate that dual income tax would reduce effective average taxation by around seven percentage points. This would make Germany considerably more attractive to US (and other foreign) investors (see section 72 onwards).

Cost of capital can be used to draw conclusions on how neutral corporate taxation is in terms of choice of finance and legal form. They also indicate how competitive businesses operating at a given location are and what effects a tax system has on investment. The lower the cost of capital, the more competitive the businesses involved are and the more they invest. Micro-econometric estimates indicate that investment tends to respond comparatively strongly to changes in cost of capital as a result of tax.¹⁵ Dual income tax reduces the cost of capital considerably and harmonises it for different sources of finance and corporate forms (see section 68 onwards).

Instead of the cost of capital, we could also use effective marginal tax rates in assessing how neutral tax is in relation to decision-making and what effects it has on additional investment. As the information content of both indicators (cost of capital and effective marginal tax rates) is essentially identical, we will limit ourselves to looking at the cost of capital here.

65. Making Germany more attractive and encouraging investment by reducing the cost of capital and effective average tax rates means losing revenue from taxing businesses. Whether tax reforms are politically feasible largely depends on the extent of these *revenue effects*, which depend, in turn, on how businesses respond to changes in taxation. One major example was the collapse of revenues from corporation tax in Germany in 2001-2002 following the passing of the tax reduction law 2001. Based on plausible assumptions, dual income tax can be expected to reduce tax revenues by around EUR 26.7 bn purely through *rate and system effects* (see section 80 onwards). We have not offset this with any increases in tax revenues from broadening the tax base by abolishing tax breaks. The reduction in tax revenues would be much less severe if the tax base were expanded or if the tax rate on capital income were more than 25%. On the other hand, this would mean compromising on the aim of making Germany more attractive for international investment. Loss of revenue could also be limited by not including capital income via an additional proportional band in the progressive rate schedule as is

¹⁴ See Devereux and Griffith (1998: 363).

¹⁵ Harhoff und Ramb (2001: 66 pp.) and Chirinko and von Kalkreuth (2002: 28 pp.) estimate that the elasticity of investment as a function of user cost of capital is around -0.5. Reducing user cost of capital by 10% would, therefore, increase the volume of investment by 5%.

proposed here, but taxing it at 25% across-the-board; but that might mean capital owners were worse off in tax terms than they are under the status quo.

Reforming personal income and corporate tax via dual income tax could shift the tax revenues accruing to different level local authorities. This would have to be allowed for by redistributing VAT revenues between Federation, federal states and local authorities.

66. These estimated revenue effects do not take account of the fact that the improved investment conditions and, hence, increased employment would also result in an increase in tax revenues and, thus, be self-financing to some extent. The remaining loss of tax revenues would have to be balanced by reducing expenditure, increasing other taxes or increasing public debt. The macro-economic effects of tax reforms on investment, employment and growth, thus, depend on the combined effects of reducing tax on business and the compensatory financing mechanisms employed to preserve revenue neutrality. These can only be calculated by using a fully specified macro-economic model. Calculations using a *dynamic numerical equilibrium model* indicate that introducing a dual income tax would have significant positive effects on investment, employment and the gross domestic product in the long term (section 89 onwards).

67. Calculating cost of capital and effective tax rates, revenue effects and the macro-economic effects of tax reforms is based on a variety of different models and records, each of which provides specific insights into the different effects of a dual income tax. Taken together, they make it possible to give a comprehensive assessment of what effects tax reforms are likely to have.

1.3.1 The Cost of Capital and Effective Average Tax Burdens

1.3.1.1 Making Germany More Attractive for International Investment

68. In estimating cost of capital and effective tax rates for outbound investment we have included 12 European countries: Germany, France, the United Kingdom, Ireland, Italy, the Netherlands, Sweden, Finland, Poland, Slovakia, Austria and Hungary. They have been selected for their economic importance, their proximity to Germany and how they tax capital income at present. In considering inbound investment, we also include the United States when considering where foreign parent corporations are based.

Where business decides to locate depends on how much its profits will be taxed on average. This is mainly a matter of taxes on corporate profits, as investment abroad is mostly realised via corporations. We will limit ourselves in the first instance to looking at tax burdens at corporate level: This is justified with public corporations, as the marginal shareholders who are relevant to investment decisions are generally irrelevant here. Table 6 uses tax rates and effective average tax burdens to show what the status quo *for domestic business activities* was in 2005.

Effective average tax rates were calculated for corporations equally investing in five classes of fixed assets (purchased intangible fixed assets, buildings, machinery, financial assets and inventories), financing them equally one third each via retained profits, injecting fresh equity capital and taking up debt. Effective average tax rates and costs of capital are computed following the approach of Devereux and Griffith (1998). The most important assumptions to the model applied here are also outlined in European Commission (2002).

Table 6. Statutory profit tax rates and effective average tax burdens on companies on business in their own country – Corporate level (in %)

Company location	Statutory tax rate	Effective average tax rate
Germany		
2005 law¹⁾	39.35	36.80
Dual income tax (DIT)	25.00	23.10
Austria	25.00	23.60
Finland	26.00	25.10
France	34.93	35.70
Hungary	17.71	18.10
Ireland	12.50	15.00
Italy	37.25	32.90
Netherlands	31.50	29.20
Poland	19.00	17.40
Slovakia	19.00	17.20
Sweden	28.00	25.40
United Kingdom	30.00	29.50

1) Legal position as of 2005.

69. In 2005, as in previous years,¹⁶ Germany had the highest statutory rates of tax and the highest effective average tax rates. There are huge tax rate differentials when compared with, in particular, Ireland and the new EU Member States but also the Scandinavian countries Finland and Sweden. In some cases, these differences in taxation were even more pronounced in 2005 than they had been in previous years since Finland, the Netherlands and Austria slashed corporate taxes this year, and Italy, Poland and Slovakia had done so the year before. Such differences in tax provide considerable incentives to relocate profits from one country to another via intra-group transfer pricing and more complex group-financing arrangements or to move investment to lower-taxed countries abroad. Table 6 shows that switching to a dual income tax system as proposed here would either completely remove such incentives or considerably reduce them at least.

¹⁶ See German Council of Economic Experts (2005: section 394).

1.3.1.1.1 Outbound Investment

70. Any more precise analysis of how attractive a country is in terms of taxation must inherently include *cross-border investment*. We will, therefore, start by looking at a parent corporation based in Germany which holds 100% of the shares in a subsidiary. This subsidiary can be based or managed abroad or in Germany. Comparing the tax burden on investments a foreign subsidiary makes (*outbound investment*) with that on domestic investment will, then, indicate how attractive Germany is in the eyes of German investors.

The subsidiary funds itself in equal proportions via retained profits, internally within the group via new equity and a loan from its parent corporation. In the opposite direction, dividends and interest flow from the subsidiary to the parent corporation. The parent corporation, in turn, finances itself equally via new equity, retained earnings and acquiring debt. Where the subsidiary invests in Germany, we assume that the subsidiary and the parent corporation are a consolidated fiscal unit for tax purposes.

Table 7. Ranking locations by tax burdens on investments by German companies in Germany and abroad (Outbound investment)

Subsidiary location			
Effective average tax burden (%)			
Legal position as of 2005		Dual income tax	
1. Ireland	17.1	1. Ireland	15.9
2. Slovakia	19.2	2. Slovakia	18.1
3. Poland	19.5	3. Poland	18.3
4. Hungary	20.2	4. Hungary	19.0
5. Austria	25.5	5. Germany	23.1
6. Finland	27.1	6. Austria	24.4
7. Sweden	27.3	7. Finland	26.0
8. Netherlands	31.0	8. Sweden	26.3
9. United Kingdom	31.4	9. Netherlands	30.0
10. Italy	34.7	10. United Kingdom	30.3
11. Germany	36.8	11. Italy	33.6
12. France	37.4	12. France	36.4
13. United States	44.1	13. United States	43.1

71. Table 7 shows the effective average tax rates for outbound investment at alternative locations under 2005 conditions and if dual income tax were introduced by way of ranking locations. The calculations take account of relevant provisions of the respective foreign and domestic tax law including double taxation treaties. When considering what the optimum funding decision would be for tax purposes, investment locations remain ranked in the same order as they would be if the sources of funding were equally weighted.

Under the current law, it is more advantageous to invest via a subsidiary based in a European country – except France – than in Germany. Reducing the tax bur-

den on corporations to 25% as part of a dual income tax system, on the other hand, would put Germany in *fifth position* as a place to invest, out of the countries considered here. Compared with investing at home, only in Ireland, Slovakia, Poland and Hungary would tax burdens be less; but as the differences in taxation between these countries and investing in Germany would be considerably reduced, that reduces the tax incentive to investing in those countries as well.

Table 8. Ranking locations by tax burdens on investments by foreign corporations in different countries (Inbound investment)

Location of corporation	Subsidiary location			
	Effective average tax rates (%)			
Austria	1. Ireland	15.0	8. Sweden	25.4
	2. Slovakia	17.2	9. Netherlands	29.2
	3. Poland	17.4	10. United Kingdom	29.5
	4. Hungary	18.1	11. Italy	32.9
	5. Germany (DIT)	23.1	12. France	35.7
	6. Austria	23.6	13. Germany (2005)	36.8
	7. Finland	25.1	14. United States	42.5
France	1. Ireland	16.3	8. Sweden	26.6
	2. Slovakia	18.5	9. Netherlands	30.3
	3. Poland	18.7	10. United Kingdom	30.6
	4. Hungary	19.4	11. Italy	33.9
	5. Germany (DIT)	24.3	12. France	35.7
	6. Austria	24.8	13. Germany (2005)	37.7
	7. Finland	26.3	14. United States	43.4
Hungary	1. Ireland	15.2	8. Sweden	25.6
	2. Slovakia	17.4	9. Netherlands	29.4
	3. Poland	17.6	10. United Kingdom	29.7
	4. Hungary	18.1	11. Italy	33.1
	5. Germany (DIT)	23.3	12. France	35.9
	6. Austria	23.8	13. Germany (2005)	37.0
	7. Finland	25.3	14. United States	42.7
Poland	1. Slovakia	17.2	8. Sweden	25.4
	2. Poland	17.4	9. Netherlands	29.2
	3. Hungary	19.4	10. United Kingdom	29.5
	4. Ireland	19.6	11. Italy	32.9
	5. Germany (DIT)	23.1	12. France	35.7
	6. Austria	23.6	13. Germany (2005)	36.8
	7. Finland	25.1	14. United States	42.5
United Kingdom	1. Slovakia	27.0	8. Hungary	29.0
	2. Poland	27.3	9. Netherlands	29.2
	3. Germany (DIT)	27.6	10. United Kingdom	29.5
	4. Sweden	27.8	11. Italy	32.9
	5. Austria	28.0	12. France	35.7
	6. Ireland	28.2	13. Germany (2005)	36.8
	7. Finland	28.6	14. United States	40.0
United States	1. Slovakia	36.7	8. Ireland	37.7
	2. Italy	36.8	9. Finland	38.0
	3. Poland	36.9	10. Hungary	38.3
	4. Germany (DIT)	37.1	11. United Kingdom	38.8
	5. Sweden	37.3	12. Germany (2005)	39.4
	6. Netherlands	37.4	13. United States	40.0
	7. Austria	37.5	14. France	40.5

1.3.1.1.2 Inbound Investment

72. Dual income tax would also make Germany much more attractive to investors based abroad. By way of illustration, let us assume a parent corporation based in a number of countries investing via subsidiaries which, in turn, are based in different countries. We will assume once again that both parent corporation and subsidiary finance themselves equally via the three sources of finance. Reducing the statutory tax burden on corporations in Germany would have an immediate effect on effective average tax burdens of parent companies located abroad if the other country exempts profits made in Germany from tax. But, even if that other country uses the credit method, this would still reduce the effective tax burden as the excess credits which arise from current high rates of tax in Germany would be reduced or eliminated altogether by switching to dual income tax.

73. As Table 8 shows, to investors resident in Europe, Germany is, at present, the least attractive place to do business in tax terms. To US parent corporations, Germany comes second to last ahead of France. Switching to dual income tax would make Germany much more attractive. To parent corporations based in France, Austria, Poland and Hungary, Germany would be the *fifth best* place to invest after Ireland, Poland, Slovakia and Hungary. For UK and US corporations, Germany would even be the *third or fourth place*, respectively, for investing via subsidiaries. At the same time, this would increase the incentive to finance the German subsidiary with equity rather than with debt capital.

1.3.1.2 Decision-Making Neutrality and Competitiveness

74. As Table 9 shows, the current income and corporation tax system often leads to distortions when making financing decisions, investment decisions and deciding what legal form to use. It shows the cost of capital and average effective tax burdens for corporations and partnerships investing in five different types of fixed assets, opting to finance this out of retained earnings via fresh equity or debt. To make any meaningful comparison between partnerships and corporations, the latter must include shareholders. Individuals are generally assumed to be paying the top rate of income tax. To a typical SME, disposing of shares in the business does not play a major role. The calculations in Table 9, therefore, assume no shares will be sold.

75. *The cost of capital* enables us to state to what extent tax distorts business decisions. The cost of capital is defined as the real rate of return before tax which any *additional* investment must make as a minimum requirement for it to be worthwhile compared with investing in fixed-rate securities, for example.¹⁷ If there were no tax, cost of capital would be equal to the capital market rate of interest. Our calculations assume an exogenously given capital market rate of 6%

¹⁷ See German Council of Economic Experts (2001: box 7).

and inflation at 1.92%. In that case the real capital market rate is 4%.¹⁸ If the real cost of capital of investing in a given fixed asset are less than this alternative return, this indicates that this investment is preferable in tax terms due either to special accounting provisions or a lower rate of tax. Secondly, the cost of capital governs the long-term minimum price threshold at which, if a corporation exceeds it, it will be forced out of the market. It follows that cost of capital is also an indicator of how competitive corporations are which are based in different locations and competing in the same markets via exports, for example.

Table 9. Cost of capital and effective average tax rates in Germany (in %)

	Years	Corporation (investor ¹⁾)			Transparent entities ¹⁾		
		Self-	Equity-	Debt-	Self-	Equity-	Debt-
		finance			finance		
Intangible fixed assets							
Cost of capital	2005 law ²⁾	2.40	3.94	3.52	2.74	2.74	2.63
	DIT	3.26	3.26	3.26	3.26	3.26	3.26
Effective average tax rate	2005 law ²⁾	37.38	41.10	40.07	32.45	32.45	32.15
	DIT	32.22	32.22	32.22	32.70	32.70	32.70
Buildings							
Cost of capital	2005 law ²⁾	2.96	4.50	4.07	3.35	3.35	3.24
	DIT	3.84	3.84	3.84	3.84	3.84	3.84
Effective average tax rate	2005 law ²⁾	38.72	42.46	41.42	34.13	34.13	33.83
	DIT	33.89	33.89	33.89	34.35	34.35	34.12
Machines							
Cost of capital	2005 law ²⁾	2.78	4.32	3.89	3.24	3.24	3.13
	DIT	3.52	3.52	3.52	3.52	3.52	3.52
Effective average tax rate	2005 law ²⁾	38.29	42.01	40.98	33.83	33.83	33.52
	DIT	32.96	32.96	32.96	33.43	33.43	33.43
Financial assets							
Cost of capital	2005 law ²⁾	3.52	5.06	4.63	4.22	4.22	4.11
	DIT	4.00	4.00	4.00	4.00	4.00	4.00
Effective average tax rate	2005 law ²⁾	40.08	43.81	42.77	36.54	36.54	36.24
	DIT	34.35	34.35	34.35	34.80	34.80	34.80
Stocks							
Cost of capital	2005 law ²⁾	2.30	3.84	3.41	2.60	2.60	2.49
	DIT	3.38	3.38	3.38	3.38	3.38	3.38
Effective average tax rate	2005 law ²⁾	37.12	40.85	39.82	32.07	32.07	31.76
	DIT	32.56	32.56	32.56	33.03	33.03	33.03
All assets							
Cost of capital	2005 law ²⁾	2.79	4.33	3.90	3.23	3.23	3.12
	DIT	3.60	3.60	3.60	3.60	3.60	3.60
Effective average tax rate	2005 law ²⁾	38.32	42.05	40.46	33.80	33.80	33.50
	DIT	33.19	33.19	33.19	33.66	33.66	33.66

1) Investors and transparent entities subject to top rate of tax. - 2) Legal position as of 2005.

¹⁸ The rule here is $(1 + i) = (1 + r) * (1 + \pi)$, where i is the nominal, r the real capital market rate of interest and π the rate of inflation.

76. Calculating cost of capital under tax law as in 2005 shows that, for corporations, it is better to finance investment out of retained earnings for tax purposes than acquiring debt or equity finance. We can conclude from this that new, dynamic corporations are at a disadvantage in tax terms if they have not yet accumulated the profit reserves out of which to finance their investment. Small and medium-sized corporations are also at a disadvantage in that they are subject to restrictions on acquiring debt and, therefore, are compelled to raising new equity.

For partnerships, financing investment through debt is better for tax purposes than financing it out of their own resources. Debt and equity finance is more favourable for partnerships than for corporations although they, for their part, are better off financing out of their own resources. For homogeneous products, businesses with lower cost of capital can force those with higher cost of capital out of the market by reducing their prices: Thus, different costs of capital distort competition and result in resources being inefficiently allocated.

As the law stands, when it comes to the *effective average rate of tax*, corporations pay nearly seven percentage points more than partnerships. From an economic standpoint, taxing different sources of finance and legal forms differently makes no sense. It not only leads to capital being employed inefficiently, it also provides considerable room for creative accounting and, hence, makes the tax system more complicated.

77. *Dual income tax* would overcome the tax distortions when deciding on how to finance additional investment irrespective of legal form. It would also create a more level playing field in tax terms. For any given asset, the cost of capital would be the same irrespective of legal form. Admittedly, there would still be different depreciation rules and, hence, different cost of capital for the individual assets, but those differences would be much reduced. While it would not put different legal forms on absolutely the same basis in terms of effective average tax rates, it would at least bring them much closer together. Dual income tax would turn the tax handicap corporations suffer of around seven percentage points under the law as it stands into a slight tax advantage of around half a percentage point.

1.3.1.3 Competitiveness of Small and Medium-Sized Businesses

78. Model calculations for typical representative enterprises show in detail where small and medium-sized businesses stand when it comes to competing on tax. Using the *European Tax Analyzer of ZEW and Mannheim University*,¹⁹ we took a typical SME in the manufacturing industry to see how the dual income tax as proposed would affect effective tax burdens in Germany and how German tax conditions differ from another eleven countries. We assumed in all cases that the businesses themselves and their shareholders were resident in the same country. We ran this tax burden analysis separately at corporate level and the overall level including shareholders. For the overall view, in comparing conditions in Germany, we took a corporation and an otherwise identical partnership.

¹⁹ See Jacobs and Spengel (2002).

Table 10 shows the effective tax rates *at the corporate level* in the twelve countries compared. Our model-firm in the manufacturing industry here is trading as corporation. Under 2005 conditions, Germany is last but one: Only France effectively taxes businesses more. Under a dual income tax system, on the other hand, Germany would be much better placed, that is in fifth position with an effective tax burden reduced by around 36%.

Table 10. Effective tax burdens in international comparison: Corporations, 10-year period

Company based in	Tax burden		
	Euro	Legal position as of 2005	Dual income tax
		Ranking	
Germany			
2005 law	1,837,550	11	.
Dual income tax (DIT)	1,171,456	.	5
Austria	1,723,723	9	10
Finland	1,246,925	5	6
France	2,306,050	12	12
Hungary	1,417,023	7	8
Ireland	660,223	1	1
Italy	1,737,907	10	11
Netherlands	1,429,062	8	9
Poland	928,403	3	3
Slovakia	895,473	2	2
Sweden	1,294,971	6	7
United Kingdom	1,150,090	4	4

Table 11 shows the *total tax burden* for this model corporation including shareholders. Compared with the case considering matters at corporate level only, the order in which countries are ranked has changed considerably. Ireland, which taxes business least, now falls to eighth position. France has the highest tax burden as before. For Germany, the picture is as follows: Under the law as it stood in 2005, *overall tax burdens* on corporations and shareholders have fallen three positions compared with corporate level alone. Under a dual income tax system as proposed, Germany would have the third lowest tax burden of all countries studied after Slovakia and Poland. For *partnerships*, the total burden under the law effective in 2005 is still rather less than for corporations. Under dual income tax, the total tax burden falls by around 34%, putting German partnerships in second place behind Slovakia. One point to note is that, in terms of tax burden, German SMEs already occupy a mid position under the current law when compared internationally. Dual income tax as proposed would improve the tax position lastingly; of the twelve countries considered, it would put Germany in fourth position in terms of corporations and in second position in terms of partnerships.

Table 11. Effective total tax burden in international comparison: Status quo, 10-year period

Company based in	Total tax burden		
	Euro	Legal position as of 2005	Dual income tax
		Ranking	
Germany			
2005 law			
Corporations	2,553,348	9	.
Partnerships	2,500,817	7	.
Dual income tax (DIT)			
Corporations	2,112,634	.	4
Partnerships	1,642,436	.	2
Austria	2,604,987	11	11
Finland	2,281,987	3	5
France	3,077,946	13	13
Hungary	2,578,613	10	10
Ireland	2,531,097	8	9
Italy	2,359,143	5	7
Netherlands	2,383,098	6	8
Poland	1,689,003	2	3
Slovakia	1,042,487	1	1
Sweden	3,045,331	12	12
United Kingdom	2,287,580	4	6

79. As the results presented in Tables 9, 10 and 11 show, dual income tax meets the objectives of a business tax reform – making Germany more attractive for international investors, improving its competitiveness and ensuring decision-making neutrality.

1.3.2 Effects on Tax Revenues and on Macro-Economic Variables

80. Reducing the tax on part of the corporate profits with the aim of making Germany more attractive as well as taxing all income defined as capital income at the reduced rate would mean losing tax revenue. Before implementing any tax reforms but also to make different tax reform proposals comparable, we need to estimate what effects the proposals will have on *tax revenue*. There is not much point in setting off the revenue effects determined against additional revenue, such as from measures to broaden the tax base, for example. If the list of actual or presumed tax loopholes to be abolished is only set extensively enough, the net revenue effects can be reduced accordingly. For a meaningful assessment of the revenue effects of a given reform proposal and for comparing different tax reform proposals, what is more important are the revenue effects involved in changing rates and the inherent systematic characteristics of a given tax reform strategy. This alone will tell us how much offsetting financing each tax reform proposal needs.

81. Making Germany more attractive means reducing the tax rates on corporations. To ensure decision-making neutrality and to improve competitiveness, this tax relief must be extended to transparent entities. It follows that *revenue losses are unavoidable* if we are to achieve the aims of reforming business tax. Only if we include counter-financing mechanisms, any reform of business taxation can be *revenue-neutral*.

82. The only meaningful basis for comparing competing tax reform proposals in terms of what effects they are likely to induce is that the revenue effects are more or less identical. Just because a given reform model means losing less revenue does not make it “better”: Since if we reduce tax revenue losses, that also means we will fall further short of our target making Germany more attractive to international investors.

The *dual income tax model* as proposed here, at a reduced tax rate of 25%, would mean losing tax revenues of around EUR 26.8 bn. Setting the capital income tax at 30% would reduce revenue losses from switching to a dual income tax system by around EUR 10 bn, at around EUR 17 bn. As a rough rule of thumb, each additional percentage point by which we increase capital income tax would approx. raise another EUR 1.1 bn from corporations and EUR 0.8-0.9 bn from partnerships. To ensure finance neutrality, if the tax rate were 30% on return components and debt interest, the final withholding tax rate on dividends and capital gains would have to be reduced to around 20%, however. This loss of tax revenue is considerable but is ultimately inevitable if the aims of reforming business tax are to be achieved. Making Germany more attractive as a location for international investment inevitably comes at a price.

83. In estimating the revenue effects a dual income tax as proposed here would have, we have assumed that tax law changes on a number of counts, as follows:

- For corporations
 - Tax rate at corporate level reduced to 25% including solidarity surcharge and a local (authority) profits tax;
 - Dividends and capital gains upon the disposal of shares in Germany and foreign corporations to be tax-exempt up to a return allowance;
 - Dividends and capital gains in excess of return allowance to be taxed at 25%;
- For partnerships and sole traders (with balance sheet accounting)
 - Return on equity capital to be taxed (at most) at the reduced rate of 25%, any profits over and above that to be taxed as under T 2005;
- Interest income to be taxed at 25%.

84. In estimating revenue effects, we have made a number of technical assumptions, as follows:

- The tax rates assumed should include a local tax on profits or income whatever form it takes. In calculating the revenue losses from reducing the tax rate to 25%, we assume that trade tax is abolished. The results would be similar if we

retained trade tax but allowed it to be credited against personal income and corporation tax. The main difference would be in how the revenues were distributed amongst the federal level, the States and local authorities.

- Corporation tax is reduced to 23.70%, giving a tax burden of 25% including solidarity surcharge.
- As no information is available on acquisition costs of shares in corporations, the return allowance is calculated not at shareholder level as actually proposed but derived from corporate accounts. This means that any additional income from taxing capital gains has to be ignored.
- Around 30% of profits by partnerships and sole traders are assumed to be return on equity capital and are taxed at the reduced rate.
- Any increase or reduction in revenues from taxing cross-border dividends is ignored, as there is no useful information available on this.

85. The loss of revenue from abolishing trade tax, assumed here for calculation purposes, was based on a calculation model developed by the commission on reforming local government finance. Abolishing the ability to deduct trade tax as operating costs from corporation and income tax as well as the possibility to credit trade tax against personal income tax setoff under § 35 ITA would increase revenues from personal income and corporation tax.

The corporation's profits liable to corporation tax are derived as a rough estimate from the adjusted corporation tax revenue and assumed to be EUR 118.9 bn. Deducting standard rate tax on the corporate level at 25% leaves the maximum amount available for dividends at EUR 89.2 bn. The equity capital is determined based on the Deutsche Bundesbank's corporate accounts statistics. Extrapolated, this gives total assets of EUR 2.73 bn.²⁰ At an equity capital ratio of 22% in 2003, this gives an equity capital of EUR 601 bn. This is assumed to be equal to the costs of acquiring the shares. At a 6% standard rate of return and assuming corporation taxes have already been deducted, this gives a return allowance for the shareholders of around EUR 27 bn [$601 \times 0.06 (1 - 0.25)$]. Dividends in excess of the return allowance are taxed at 25%. The income tax revenues depend on assumptions as to how many dividends are paid out: They vary from zero on dividends up to the value of the return allowance and around EUR 15.5 bn if the corporation's profits are distributed as dividends immediately after deducting the standard rate tax at corporate level. Assuming that 20% of the profits in excess of the return allowance and taxed at corporate level are paid out as dividends, this amounts to income tax revenues of EUR 3.1 bn. Allowing for the reduction in revenues from abolishing the current half income method for taxing dividends at the shareholder level of around EUR 1.75 bn, this leaves the additional revenue of EUR 1.35 bn as shown in Table 12.

²⁰ See Deutsche Bundesbank (2005: 33 pp.). The figure given for 2003 is EUR 2.045 bn. Assuming a coverage level of around 75%, extrapolating this gives total assets of around EUR 2.73 bn.

Table 12. Dual income tax and its impact on revenues compared with legal position as of 2005 in Germany (Full-year effect)

Action	€ m
1. Abolishing/setting off trade tax	- 19,870
2. Cutting corporation tax to 23.70%	- 1,560
3. Taxing dividend distributions by corporations ¹⁾	1,350
4. Taxing return on equity capital of transparent entities at reduced rate	- 6,700
Total	- 26,780

1) Dividend distributions correspond to 20% of profits after taxes, exceeding the return on equity capital.

Source: Own estimate

The loss of tax revenue which arises in income tax through allowing for a variable proportional band for capital income in the personal income tax schedule (section 47 pp.) is mainly determined by dividing the partnership's total profits into a moderately taxed return component and a progressively taxed earnings component. Analysing the Deutsche Bundesbank's business accounts statistics, we find that income from business has to be given a return component of 29% of total profits. For income from agriculture and forestry and income from self-employment, a return component of 10% would seem reasonable. Allowing for a reduced tax rate on debt interest of 25% and using T 2005 with the additional proportional band gives a loss of tax revenue from income tax of around EUR 6.7 bn.

86. The loss of tax revenues a dual income tax would involve in the first full year, on the assumptions made as above, would work out at around *EUR 26.8 bn* at a capital income tax rate of 25%. But, please note this is the loss of revenue which would occur from the rates used and the characteristics of the dual income system in isolation *ignoring any counter-financing measures* through broadening the tax base. Only these revenue effects give a true and realistic picture of the loss of revenue that can be expected.

87. It must be stressed that these are rules of thumb calculations albeit plausible ones. One critical assumption concerns how dividends are paid: This may vary upwards or downwards in any one year. Some revenue effects have also been ignored completely, because it is impossible to make any reliable statements on the basis of the data available. This applies to any increase in revenues resulting from consistently taxing capital gains – including in letting and leasing – as well as to any shifts in revenue in favour of the German tax authorities in connection with financing inbound and outbound investment. We have also ignored any possible self-financing effects of switching to a dual income tax system, for lack of any reliable empirical estimates. That such positive revenue effects will apply can be taken as read, because the calculations in section 68 pp. show that a dual income tax would make Germany much more attractive to both domestic and foreign investors in tax terms. As we do not know how much these revenue effects

from taxing a higher portion of profits in Germany are likely to be, we have ignored them here. Thus, the estimated loss of tax revenue represents an upper limit.

88. Reforming personal income and business taxation via a dual income tax system should help make Germany more attractive in tax terms and ensure decision-making neutrality, leading to more investment, employing capital more efficiently and, hence, creating jobs and growth. These macro-economic effects have been neglected to date. While the estimated cost of capital and effective tax rates lead us to conclude that a dual income tax would make Germany more attractive to invest in, they do not enable us to make any more precise statements as to how this would influence investment, let alone jobs or growth. This requires macro-economic simulation models reflecting how corporations decide to invest and finance themselves, how private households decide to consume or save and how the federal and state governments decide to spend and raise revenues and adjust themselves in line with changing tax conditions.

89. *Dynamic numerical equilibrium models* are the best models to determine the effects of reforming capital income taxation on key macro-economic variables such as gross domestic product and to identify how it is produced and used. We have estimated these effects using the dynamic equilibrium model *ifoMOD* developed by the ifo-Institut, Munich. This model is the most advanced of its kind.

On the business side, the model distinguishes between corporations and transparent entities, which are subject to corporation tax and personal income tax, respectively. Investment decisions are guided by maximising the market value of the firm allowing for adjustment costs. The model covers endogenous financing decisions and international portfolio investments influenced by tax. A typical private household makes decisions on how to save, consume and work over its life cycle. The State levies corporation taxes, income tax and value added tax and uses them to finance transfers. The model is completed by allowing for market equilibrium conditions for national and international transactions. It assumes the production potential is growing by 1%.²¹ The elasticities required to calibrate the initial equilibrium are taken from relevant econometric literature.²² Thereafter, we simulate the transition from the tax system as operated in 2004 to the dual income tax system proposed here. To preserve revenue neutrality, we assume that value added tax is increased by two percentage points, the remaining balance being financed by abolishing transfers.

90. While numerical equilibrium models are necessarily highly stylised, they do manage to give an impression of what order of effects tax reforms can be expected to have. It turns out that introducing the dual income tax as proposed will have beneficial effects on Germany's gross domestic product, capital stock, jobs,

²¹ This is in line with the results of current estimates of the potential growth rate by the German Council of Economic Experts (2005: section 122).

²² For a detailed description of the model and parameter values used, see Radulescu (2005) or Stimmelmayer (2006).

gross salaries and disposable income, domestic consumption and welfare in the long run (Table 13). In the long run the gross domestic product would be 4.7% higher than under identical conditions without the tax reforms a considerable level effect. Introducing dual income tax would increase the capital stock by as much as 9.8%, which implies it would boost investment considerably. It would also benefit private consumer demand, demand for labour and aggregate welfare.

Table 13. Long-term impact of switching to dual income tax (Changes in % compared with reference path without tax reform)

Gross domestic product	4.7
Capital stock	9.8
Demand for labor	1.1
Domestic consumption	2.3
Welfare gains	
- As % of life-time income	1.4
- As % of GDP	0.8
For information: Increase VAT by two percentage points to preserve revenue-neutrality	

2 Taxing Corporations and Their Shareholders

2.1 Taxing Corporations

91. The proposals for reforming business tax as set out here are based on the principle that *corporations* should be taxed on their profits retained and distributed as dividends at 25%. This rate is dictated by political common sense. The competition for investment in Europe and beyond shows that an attractive rate of corporation tax is the only way to meet increasing competition from other countries. This is not to overlook the fact that taxes also serve to finance public services, which in turn influence whether companies are willing to move in. But other countries are increasingly managing to combine favourable tax structures with offering adequate services as an attractive ‘bundle’; the Federal Republic of Germany must also attempt to follow such a location policy.

92. This total tax burden of 25% must not be limited merely to the rate of corporation tax but must also include other charges in the field of *local government tax*. Therefore, the rate of corporation tax ultimately depends on whether trade tax is preserved or whether local government finances are reorganised. If trade tax is perpetuated or some other local government tax is introduced (such as the ‘local business tax’ as the *Stiftung Marktwirtschaft* proposes), corporation tax must be further reduced accordingly to give a total tax burden of 25%. Another pragmatic option would be to *set trade tax off against corporation tax* along the lines of § 35 ITA.

93. This opinion does not propose any major changes in terms of how *income is calculated*. The system conversions proposed here could be implemented both under the law as it stands of referring tax accounts to German generally accepted accounting principles and if profits were independently calculated for tax purposes. To what extent, given the EU-wide efforts to create a common tax base, international accounting principles (IFRS) could be used as the basis for calculating profits for tax purposes needs to be examined more closely. How this question is answered is irrelevant to introducing a dual income tax. Opting for dual income tax is not an obstacle to creating a common EU-wide tax base in the long term.

94. As under current law, corporation tax should continue to be a definitive tax, subjecting profits earned in the corporate sector to a *definitive tax* until they are transferred to individual shareholders liable to income tax. The exemption of dividends between corporations and profits upon the disposal of shares in corporations by entities subject to corporation tax as is currently regulated under § 8b para. 1 and 2 CTA should, therefore, remain as it is. To retain the logical correctness of corporate taxation, the non-deductibility of losses and writedowns in connection with shares in corporations should also be retained (§ 8b para. 3 cl. 2 CTA; an exception could be made for losses on liquidation). This, once again, would ultimately mean that corporate profits are only taxed once at the time they arise, if those profits are distributed to corporations as dividends or paid for in the price when acquiring shares from other corporations. In other words, dual income tax does not require any intervention in corporation tax law. Nor does opting for a dual income tax prejudice the decision as to how group taxation is to be designed in future.

95. *Intra-group profit transfers* via dividends and disposals of shares is not entirely free from corporation tax at present, however. In fact, 5% of the dividends (§ 8b para. 5 CTA) and profits on disposals (§ 8b para. 3 CTA) are subject to corporation tax (and trade tax).²³ For corporate taxation as proposed here, this widely criticised 5% limit cannot be considered any differently than under the current law. Making dividends taxable at 5% is problematical for dividends from German companies on account of the constitutional law demands of the ‘objective net principle’ and is also open to doubt for dividends from foreign companies on account of the demand for non-discriminatory dividend taxation.²⁴ Even if the 5% dividend tax is still considered acceptable for practical reasons, the tax on profits on disposal, which was introduced only recently (as of January 1, 2004), must be abolished to avoid cascade effects and taxing business twice (§ 8b paras. 2 and 3 CTA).²⁵

96. On the other hand, the difference in tax rates introducing a dual income tax would create between favoured capital income and earnings income would require specific interventions in calculating corporate income in the case of contractual *agreements between a corporation and its shareholders*. This would mainly apply to certain agreements in connection with debt financing. On the other hand, unreasonable payments for supplies and services would not need any additional regulation: They could continue to be corrected using the conventional tools of hidden profit as well as capital contributions (section 146 pp.).

²³ See Schreiber and Rogall (2003) and Spengel and Schaden (2003).

²⁴ See Schön (2001).

²⁵ See German Council of Economic Experts (2003: section 545 and 547).

2.2 Taxing Shareholders

2.2.1 Preferential Tax Treatment for Return on Equity Capital and Regular Taxation

97. To ensure that earnings private investors obtain from holding shares in corporations are taxed reasonably, the first point to consider in this analysis is the principle of *financial neutrality* as set out in chapter 1. This principle demands that taxpayers should not, in principle, find themselves facing distorting or preventive tax rules when employing capital (equity capital or debt) or deciding how earnings should be realised (dividends or capital gains). Instead, how capital is employed and how earnings are derived from that should be uniformly taxed, no matter what source of finance is chosen. This makes investing capital attractive; however it is done, it helps simplify the tax system and minimises the room for creative accounting and abuse. It follows that all capital income from holdings in corporations, that is dividends, capital gains upon the disposal of shares and interest from debt-financing should be identically taxed.

98. The starting point for shareholders to be treated in a ‘finance-neutral’ manner as desirable for tax purposes is taxing profits at corporate level at 25% as outlined above. There are a *number of options* available to ensure that how shareholders are taxed does not affect finance decisions. This could be done, for example, by proportionately taxing interest income at 25% and making capital gains generally tax-exempt; for dividends, a full imputation system or a dividend exemption system that would be simpler to manage could apply. The German Council of Economic Experts presented such a tax system, which would finance-neutrally apply to *all capital income*, irrespective of how much, in its reform model as originally presented in its annual report for 2003/04.²⁶

99. What we are now proposing is a further development of that earlier model in the light of further work which current developments in Finland and Norway are also taking up. These modifications have a number of goals: First, they aim to avoid the *risk of losing tax revenue* which would be threatened if dividends and capital gains were exempted or if corporation tax could be imputed. They are also aimed at preventing individuals from trying to ‘reclassify’ higher-taxed labour income into lower-taxed capital income. Finally, they aim to reinforce the principle of *neutrality as to legal form* and, hence, generally to prevent all profits made by corporations being tax-exempt. The dividend exemption as previously proposed for all dividends and tax exemption for profits upon disposals of shares are, therefore, generally abandoned.

²⁶ See German Council of Economic Experts (2003: section 571 pp.).

100. The proposed model *divides* income by shareholders into a *favourably taxed return on capital* on the one hand and an earnings component subject to *standard tax rates* on the other:

- Insofar as the return on capital employed can be regarded as the standard return on capital, dividends and capital gains upon the disposal of shares are *tax-exempt* (the ‘return allowance’).
- Under this modified dual income tax, any dividends and capital gains over and above the return allowance are subject to *additional tax*. As to the level of this additional tax, it would be advisable to use a proportional tax rate again of 25% and levy it by way of final withholding tax. An assessment option should also be granted.

101. The taxation of corporate profits at the shareholder level, therefore, differentiates between the *preferential treatment of the standard return on equity capital employed* and any additional dividend payments and profits on disposals. Where shareholders are liable to income tax, dividends and profits on disposals to the amount of the standard return to capital are tax-exempt; the existing system of taxing profits upstream at corporation level at 25% remains. Any *additional shareholder earnings*, on the other hand, would be subject to additional income tax at up to 25% giving a total (maximum) tax rate of 43.75% [$0.25 + 0.25(1 - 0.25) = 0.4375$]. This is about equal to the top rate of personal income tax (42.00%) which, including the solidarity surcharge of 5.50%, is 44.31% [$0.42(1 + 0.055) = 0.4431$]. These rules apply irrespective of whether shares in corporations are held as business or private assets for personal income tax purposes.

102. As a general rule, taxpayers and tax authorities would accept this *proportional tax at source* being levied, also given that taxpayers can and will have major items to deduct from their other income, and from their labour income in particular. At the same time, this would considerably reduce the administrative workload involved in taxing capital income and also save taxpayers work. There is one particular problem, however, in the – rare – cases where taxpayers earn little or no income apart from what they earn from shares in corporations. To meet the constitutional requirement that *the minimum amount required for subsistence should be exempt from tax*, the application of a proportional tax (at source) on additional earnings must, therefore, be combined with an *assessment option* enabling taxpayers to claim basic allowances (for themselves and their spouses) and children’s allowances. Other personal deductions (§§ 10 ff., 33 ff. ITA) must also be provided for in this assessment. Lastly, this assessment option would also ensure that anyone whose only income is from capital can use the *lower progressive zone* up to the (marginal) tax rate of 25%. Finally, it may happen that, in earning income from capital holdings, taxpayers incur costs of earnings which, under the ‘objective net principle’, must be deductible in full. Here, an assessment option is essential as well.

103. When using the assessment options for dividends, on the other hand, we have to ensure that the tax burden on dividends above the return allowance, in-

cluding corporation tax on profits at 25%, does not exceed the maximum rate of income tax. Since from an economic point of view, we have to consider the total tax burden for shareholders and corporations together. Only by doing so can we meet the requirements of being neutral between legal forms as far as possible compared with transparently taxed entities. So we must avoid exceeding any rate of more than 25%, even if the taxpayer demands that standard tax rates (and particularly basic and family allowances) are applied to dividends above the return allowance. For this *income from holdings in companies liable to corporation tax, the tax rate must, therefore, be 'capped' at 25%*. Under the new system, this replaces the relief effects of the existing half income method or the former imputation system.

104. Dividends distributed have already been subject to corporation tax at 25%; the top rate of personal income tax on capital income is also 25%. When it comes to taxing corporate profits, dual income tax, thus, integrates corporation tax with income tax.

105. For EC law reasons, this integration mechanism must not remain strictly reserved to shareholders liable to pay personal income tax who hold shares in German companies. To avoid conflicts with the principle of freedom of establishment (EC Treaty Art. 43) and free movement of capital (EC Treaty Art. 56)²⁷, tax exemption for returns on capital must be extended to include both shareholders subject to unlimited liability to income tax²⁸ who hold shares in foreign corporations (outbound cases) and those subject to limited liability to income and corporation tax who hold shares in German corporations (inbound cases).

106. Under this taxation system, corporations are identically taxed on profits they retain and distribute as dividends, provided those dividends fall within the standard return on the capital employed. It also ensures equality of taxation when compared with financing investment through debt, because returns to investors are also taxed at 25% achieving finance neutrality for the 'marginal investment' (which earns precisely the standard return).

2.2.2 Putting Capital Gains and Dividends on an Equal Footing

107. If we consider that contract law or company law structures can be used to receive earnings from investing capital as dividends or as the proceeds on disposals, the procedure as presented here must, in principle, make profits on disposals taxable and treat them the same way as dividends. The current exemption for prof-

²⁷ To what extent the scope of free movement of capital, which is relevant to portfolio holdings, can be restricted to holdings in the rest of the EU, contrary to the wording of Art. 56 of the EC Treaty, has not yet been completely clarified (Schön, 2005).

²⁸ Shareholders liable to corporate tax are subject to the corporation tax holding privilege, as with the domestic case (§ 8b CTA).

its on disposals of shares in corporations held as private assets, which are less than 1% and are held at least 12 months after the date of acquisition, should, therefore, be abolished. There is no tax system justification for waiving tax here. Taxing profits on disposals is the only way of ensuring that income is equally treated for businesses and individuals: Capital gains taxation, therefore, is essential if dual income tax is to be finance-neutral. Finally, collecting taxes is much easier if there are no exemptions from tax. By way of example only, let us point out that making profits on disposals universally taxable would eliminate constructions whereby shares in corporations are transferred from a 'tax-exempt' seller to a 'taxpaying' buyer.

2.2.3 Assessing the Standard Rate of Return

108. The return on equity capital to be taxed at a favourable rate is determined as a 'standard rate of return' on the equity capital employed. The standard rate of return for a given period (say 3 years) must be set by law. To ensure finance neutrality, this rate of return should be based on the long-term yield on corporate bonds.²⁹ Increasing the rate of return for tax purposes can be justified with some restrictions of the objective net principle. These include such things as restricting the use of return allowances (section 137 pp.) or limiting the losses which can be claimed against tax. The latter prevents future risks of loss and profit opportunities being seen as identical through an investor's eyes. These considerations can, of course, do no more than merely estimate the standard rate of return for tax purposes. If we add a surcharge of two percentage points, with the capital market as it stands, the *standard rate of return on equity capital* could be set at 6%.

109. A 6% standard rate of return is also not that far removed from the guideline rate of 5.5% which has been used by the valuation tax act (§ 12 para. 3 cl. 2 VTA) for many years, which has also been used in tax accounting law in recent times (§ 6 para. 1 no. 3 cl. 1 and no. 3a lit. e cl. 1 ITA).

110. Setting the standard rate of return must of course remain the prerogative of democratically legitimised bodies by way of federal legislation; the politicians should accept, however, that this rate of return is not to be used primarily as an economic policy tool but is designed to ensure that debt and equity financing are equally treated in line with how capital markets actually develop.

111. Example 6 shows the tax implications of the dual income tax compared with the current law at different tax rates (Table 14). Tax liability under the dual income tax is calculated in line with Example 1/Table 1 (section 54).

Example 6: A corporation has an equity capital of 1,000 units. Its overall return on capital is 15%, while the standard rate of return for tax purposes is 6%, giv-

²⁹ See chapter 1, section 36.

ing taxable profits of 150 units. We assume corporation tax at 25%. Under the current shareholder relief system (half income method), half the dividends are tax-free. Under dual income tax, 60 units of the dividends count as standard rate of return on capital, which is to be exempt from personal income tax. As the dividends have already been subjected to corporation tax, the tax-free dividends are 45 units [= 60 (1 - 0.25)]. Under dual income tax, capital income is, in principle, subject to a proportional rate of personal income tax of 25%; lower rates of tax (here: 0 and 15%) can be used on option (section 100). Under the law as it stands, the marginal rate of income tax can rise to 44.31% (42% plus solidarity surcharge of 5.5%).

Table 14. Taxing corporations and shareholders: Half income method vs. dual income tax

(1) Profit before tax		150			
(2) Corporation tax [0.25 * (1)]		37.50			
(3) Profit after corporation tax [(1) - (2)]		112.50			
(4) Dividends		112.50			
Half-income-method (a)					
(5a) Tax-exempt dividends [0.5 * (4)]	56.25	56.25	56.25	56.25	
(6a) Taxable dividends [0.5 * (4)]	56.25	56.25	56.25	56.25	
(7a) Income tax rate in % (including solidarity surcharge)	0	15	30	44.31	
(8a) Income tax [(7a) * (6a) / 100]	0	8.44	16.88	24.92	
(9a) Dividends after income tax [(4) - (8a)]	112.50	104.06	95.63	87.58	
(10a) Total tax burden in % $\{(2) + (8a) / (1) * 100\}$	25	30.63	36.25	41.62	
Dual income tax (b)					
(5b) Tax-exempt dividends [(1 - 0.25) * 0.06 * 1 000] (= return allowance)	45	45	45	45	
(6b) Taxable dividends [(4) - (5b)]	67.50	67.50	67.50	67.50	
(7b) Income tax rate in % (including solidarity surcharge)	0	15	25	25	
(8b) Income tax [(7b) * (6b) / 100]	0	10.13	16.88	16.88	
(9b) Dividends after income tax [(4) - (8b)]	112.50	102.38	95.63	95.63	
(10b) Total tax burden in % $\{(2) + (8b) / (1) * 100\}$	25	31.75	36.25	36.25	

There is no personal income tax burden under dual income tax with a proportional rate of tax on capital income, provided that income is below the basic allowance, which is the reason why the tax burdens are identical in the example at zero tax rate. The definite burden of corporation tax at 25%, however, remains. If dividends exceed the basic allowance and are likewise taxed at 25%, this gives a uniform tax burden of 36.25%. In our example, from a rate of personal income tax of 30%, the tax burden under dual income tax is lower than under the half income method under the law as it currently stands.

112. With the dual income tax, the *total tax burden on dividends* depends on how those dividends are composed: If dividends are to be totally exempt from income tax, this gives a total tax burden at a rate of corporation tax of 25%. That is as it should be because all capital income should be subject to this uniform taxation. The higher the taxable component of dividends, the higher is the total tax burden. Where taxable dividend components are very high, the tax burden ap-

proaches the rate of 43.75%. This rate is rather higher than the top rate of 41.62% under the half income method at 2005 income tax rates, which, therefore, reduces the tax rate advantage of the half income method as compared with the top rate of income tax.

2.2.4 Return on Equity Capital – Should It Apply to the Corporation or the Shareholders?

113. The tax-exempt parts of dividends can be determined at the level of either a corporation or its shareholders. The *corporation* can determine what proportion of its profits qualifies as tax-exempt dividends by applying the standard rate of return to its equity capital at the start of the year. If those profits are distributed as dividends, its shareholders will not be liable to pay income tax on these. Alternatively, at *shareholder level*, the acquisition costs of their shares in the corporation can be multiplied by the standard rate of return to give up the limit to which dividends are exempt from personal income tax. Which method is used depends on economic, legal and administrative considerations.

- From an *economic standpoint*, the aim is to achieve finance neutrality for marginal investment, which means equally taxing dividends and profits on disposals of shares in corporations by shareholders.
- From the perspective of *EC law*, there must be no distinction in terms of taxing dividends or profits on disposals depending on where a corporation is based or whether shareholders are resident in Germany or elsewhere in the EU.
- From an *administrative standpoint*, the records taxpayers are required to keep and the inspections the tax authorities have to make should be kept to a minimum.

2.2.4.1 Differences in Calculation Methods and Financial Effects

114. If tax-exempt dividends are calculated at corporation level (method 1), taxed profits must be broken down to be able to determine what proportion of dividends is tax-exempt as far as the shareholders are concerned in the year in which those dividends are paid. This procedure is, to some extent, similar with the classification of equity capital for tax purposes as used under the German imputation system between 1997 and 2001. Under dual income tax, in principle, increase in taxed equity capital to be used for tax-exempt dividends each year is obtained by multiplying the equity capital at the start of the year by the standard rate of return after corporation tax of 4.5 ($6 - 0.25 * 6$)%. The increase in taxed equity capital to be used for taxable dividends is obtained as the difference between ‘profits after tax’ and ‘profits employable as tax-exempt dividends’. Corporations must certify the value of dividends which are to be exempt from personal income tax (*return allowance*). This means an equity disposal rule is required to be used when distributing profits by way of dividends. Dividends could start off as tax-free, only the excess being taxable.

115. If it is the *shareholders* who calculate what proportion of their dividends are tax-exempt (method 2), there is no need for the corporation to keep specific equity classification accounts for tax purposes. Thus, there are no changes compared with current corporation tax law. On the other hand, the acquisition costs of their shares must be individually determined for each taxpayer and multiplied by the standard rate of return after corporation tax of 4.5 ($6 - 0.25 * 6$)%. That gives the amount up to which dividends are tax-exempt. Return allowances not used on dividends are carried over and, at the same time, increase the return base for calculating the return allowance for the following year (this does not mean that profits are realised through increasing the acquisition costs). Dividends up to the value of past return allowances not used are also tax-exempt: The return allowances available are reduced accordingly. Any dividends in excess of this are taxable.

116. In terms of financial effects, the two methods are identical when it comes to taxing dividends. Example 7 shows the procedure to be used if dividends are immediately distributed (Table 15).

Table 15. Dual income tax: Splitting of profits at corporate level (Method 1) vs. at shareholder level (Method 2) – Immediate distribution

	Method 1	Method 2
Corporate level		
(1) Equity capital (opening balance)	1,000	1,000
(2) Profit before tax ¹⁾ [$0.15 * (1)$]	150	150
(3) Corporation tax [$0.25 * (2)$]	37.50	37.50
(4) Profit after corporation tax [(2) - (3)]	112.50	112.50
(5) Return base [= (1)]	1,000	.
(6) Return on equity capital [$0.06 * (5)$]	60	.
(7) Return allowance [$(1 - 0.25) * (6)$]	45	.
(8) Dividends	112.50	112.50
(9) Equity capital (closing balance) [(1) + (4) - (8)]	1,000	1,000
Shareholder level		
(10) Acquisition costs of shares as at 01.01.	1,000	1,000
(11) Return base [= (10)]	.	1,000
(12) Return on equity capital [$0.06 * (11)$]	.	60
(13) Return allowance [$(1 - 0.25) * (12)$]	.	45
(14) Dividends before income tax	112.50	112.50
(15) Tax-exempt dividends [(15a) + (15b)] of which:	45	45
(a) Capital repayment	0	0
(b) Return allowance (7 or 13)	45	45
(16) Taxable dividends [(14) - (15)]	67.50	67.50
(17) Income tax [$0.25 * (16)$]	16.88	16.88
(18) Dividends after income tax [(14) - (17)]	95.63	95.63
(19) Total tax burden $\{[(3) + (17)] / (2) * 100\}$	36.25	36.25

1) Return on capital 15%.

Example 7: As the year opens, a corporation is founded with an equity capital of 1,000 units. As in examples 1 and 6, the overall return on capital is 15%, and

the standard rate of return is 6%, giving taxable profits of 150 units. The standard rate of return after corporation tax at 25% gives a dividend of 45 units while the dividend attributable to additional earnings is subject to additional tax at 25%. Irrespective of whether the tax-exempt dividends are determined at corporation level (method 1) or at shareholder level (method 2), the total tax burden on profits as far as the shareholders are concerned in this example is 36.25%.

117. If the corporation retains its profits, its return base – equity capital for tax purposes (method 1) or costs of acquiring shares (method 2) – must be extrapolated by the standard rate of return to avoid double taxation of profits at the time dividends are paid. As example 8 shows, once again, both methods give the same total tax burden on dividends (Table 16).

Example 8: Continuing from example 7, it is assumed that profits are completely retained in Year 1, and the corporation is wound up at the end of Year 2.

Table 16. Dual income tax: Splitting of profits at corporate level (Method 1) vs. at shareholder level (Method 2) – Reinvesting profits in Year 1

	Method 1		Method 2	
	Year 1	Year 2	Year 1	Year 2
Corporate level				
(1) Equity capital (opening balance)	1,000	1,112.50	1,000	1,112.50
(2) Profit before tax ¹⁾ [0.15 * (1)]	150	166.88	150	166.88
(3) Corporation tax [0.25 * (2)]	37.50	41.72	37.50	41.72
(4) Profit after corporation tax [(2) - (3)]	112.50	125.16	112.50	125.16
(5) Return allowance carried over, unused	0	45	.	.
(6) Return base [(1) + (5)]	1,000	1,045	.	.
(7) Return on equity capital [0.06 * (6)]	60	62.70	.	.
(8) Periodic return allowance [(1 - 0.25) * (7)]	45	47.03	.	.
(9) Dividend	0	1,237.66	0	1,237.66
(10) Equity capital (closing balance) [(1) + (4) - (9)]	1,112.50	0	1,112.50	0
Shareholder level				
(11) Acquisition costs of shares as at 01.01.	.	.	1,000	1,000
(12) Return allowance carried over, unused	.	.	0	45
(13) Return base [(11) + (12)]	.	.	1,000	1,045
(14) Return on equity capital [0.06 * (13)]	.	.	60	62.70
(15) Periodic return allowance [(1 - 0.25) * (14)]	.	.	45	47.03
(16) Dividends before income tax	0	1,237.66	0	1,237.66
(17) Tax-exempt dividends [(17a) + (17b)]	0	1,092.03	0	1,092.03
of which:				
(a) Capital repayment	0	1,000	0	1,000
(b) Return allowance {min[(16); (5) + (8)] or {min[(16); (12) + (15)]}	0	92.03	0	92.03
(18) Taxable dividends [(16) - (17)]	0	145.63	0	145.63
(19) Income tax [0.25 * (18)]	0	36.41	0	36.41
(20) Return allowance to be carried over, unused	45	0	45	0
(21) Dividends after income tax [(16) - (19)]	0	1,201.25	0	1,201.25

1) Return on capital 15%.

Looking at the profits to be exempted from personal income tax under method 1 in Year 2 of 47.03 units (line 8), we find that this is less than the amount of 50.06 units which is obtained by multiplying the equity capital at the start of Year 2, of 1,112.50 units, by the net return for tax purposes of 4.5%. Adding 50.06 units would be too much because profits of 67.5 units (112.5 - 45) from the additional earnings, which are reinvested but not exempt at the level of the shareholders, enjoy the advantage of lower taxation. In this example, the advantage is 3.03 ($67.5 * 0.045$). The increase of the return allowance of 50.06 units must, therefore, be reduced by 3.03 units to give the amount of 47.03 units as shown in Table 16; the earnings not to be exempt are increased accordingly. Alternatively, the standard rate of return can be obtained by reducing the return base in Year 2: $47.03 = 0.045 * (1,000 + 45)$. This correction is the only means of obtaining the same tax-exempt and taxable dividends under both methods.

118. From an *administrative standpoint*, this makes determining the amount which is exempt from personal income tax at corporation level (method 1) more detrimental than determining it at shareholder level (method 2). Since at corporation level (method 1), the equity capital as shown in the capital accounts cannot be used directly: First, any profit components in excess of the standard rate of return must be eliminated from the return base. As with the former German imputation system, we need to break down the equity capital which can be used for dividends. At shareholder level, on the other hand (method 2), the acquisition costs of the shares can be extrapolated without having to correct the return base.

119. However, this means that shareholders (and/or their advisers and/or institutions which manage their assets) must divide income from share holdings into tax-exempt and taxable components. With shares in limited corporations and shares held privately, the individual acquisition costs of the shares (including subsequent acquisition costs) must be pursued and extrapolated. In the case of portfolio holdings, banks and other asset managers will have to expect to keep more detailed records. Although such records are needed for taxing profits on disposals of shares in corporations in any case, method 1 is likely to work out better since it concentrates the recording and settlement obligations on the corporation paying the dividends. Method 2, on the other hand, has the advantage of taxing the shareholders without requiring information as to how the dividends by the corporation paying them break down for tax purposes.

2.2.4.2 Dealing with Cross-Border Earnings from Shareholdings in Corporations

120. In EC law terms, with cross-border investments in corporations, the main points to consider are that any conflict with the freedom of establishment (Art. 43 EC Treaty) and free movement of capital (Art. 56 EC Treaty) must be avoided. This means that standard rate of return must be tax-exempt both for shareholders with liability to income tax with foreign shareholdings (outbound cases) and – in terms of withholding tax – for shareholders with limited liability to income tax possessing shares in German corporations (inbound cases).

121. In terms of *outbound cases*, determining the return allowance at shareholder level (method 2) is better than at corporation level (method 1). Method 1, which applies to the *corporation's* equity capital, can cause problems if the corporation which pays the dividend is not subject to tax or bound to keep accounts in Germany. Therefore, there is no information as to or to what extent dividends represent a tax-exempt return on the capital employed and to what extent they exceed the tax-exempt return and are taxable as such. As a general rule, neither the tax authorities nor shareholders resident in Germany can find out what the tax-exempt component of dividends is: Instead the corporation based abroad must *voluntarily set up accounts under German corporation tax law* to enable it to issue its shareholders with certificates and furnish information as required. If no such information is available, German tax authorities will either apply the higher rate or make a rough assessment, based on the foreign corporation's commercial accounts, for example.

122. It cannot be ruled out that these additional costs of dual income tax that ultimately affect taxable shareholders might be seen as a breach of the *non-discrimination* rule under EC law. Nor can it be denied that the information given may be incorrect. Determining the return allowance at the level of the *shareholders* (method 2) of foreign companies, on the other hand, does not create any comparable problems if those shares are held in Germany. The income tax rules are the same no matter where dividends may come from; although there may be administrative problems if other countries are involved. The German tax authorities cannot access information about holdings by tax payers subject to unlimited liability to personal income tax if those holdings are abroad (held by a foreign bank as custodian, for example), which may mean increased administrative and tracking costs. On the other hand, taxpayers have a duty to assist in clarifying the facts: They will also have an interest in their circumstances being clarified themselves, as this may mean they have to pay less income tax.

123. As far as *inbound cases* are concerned, determining the return allowance at *corporation* level (method 1) does not present any problems since a domestic corporation certifies the tax-exempt component of dividends itself. If the return allowance is determined at *shareholder* level (method 2), German tax authorities will need to know what each shareholder's holding is. That is not a problem provided the shares are in this country. Where problems do arise, however, is when shares are held abroad. Foreigners receiving dividends will have to be compelled to provide the information required if they wish to claim the return allowance. At the same time tax authorities will have to work together, to some extent, to ensure the controls required are in place. The risk of manipulation to reduce German withholding tax on capital investment could be countered by reporting the level of taxable dividends to the tax authorities in the state in which the person receiving those dividends resides.

124. Finally, it must be clearly said that exempting the standard rate of return on cross-border investment required by EC law reduces tax revenues. This equally

applies to both methods. This exemption must be granted to tax payers subject to unlimited liability to income tax on all dividends and, therefore, means that also dividends must be exempt from income tax generated by corporations that are not subject to corporation tax in Germany. As tax payers subject to limited liability to income tax are entitled to a comparable exemption, profits subject to corporation tax in Germany, therefore, migrate abroad free of income tax. What this means, in fact, is that the tax revenue shifts to the state in which the person receiving the dividend is resident. When determining the tax-exempt component of dividends, conflicts with the freedom of establishment (Art. 43 EC Treaty) and free movement of capital (Art. 56 EC Treaty) could be avoided more effectively by linking the determination of the return base to the shareholder's part (method 2).

2.2.4.3 Disposing of Shares in Corporations

125. The final substantive differences between the two methods appear if we consider the tax effects of disposing shares in corporations. The equality of taxation of dividends and capital gains to be strived for from an *economic standpoint* (finance neutrality for the marginal investment) can only be achieved by determining the standard rate of return and, thus, the return allowance at shareholder level (method 2). If someone sells a share in a corporation at a profit and if we try to determine the return allowance at the corporation level (method 1), there is no way of classifying any of the profits on disposal as tax-exempt since only the corporation has the information required, and, therefore, allowances are only possible on dividends. If we use method 2, on the other hand, we can also exempt the profits which shareholders 'include in the deal' and which are not to be taxed as the tax-exempt amount can be calculated by applying the standard rate of return to the acquisition costs each year. As it makes no difference from an economic standpoint whether a corporation distributes its profits to its shareholders or whether those profits are realised by disposing of its shares (i.e. capital gains), method 2 is, therefore, clearly preferable. Method 2, thus, applies the same principles as are used when taxing the dividends.

126. Example 9: To explain how dividends and profits on disposals of shares in corporations are equally taxed, let us extrapolate from Example 8 and assume that the shares are sold at the end of Year 1. The selling price (P) should be the level at which the seller does not mind whether he holds the shares until the corporation is liquidated at the end of Year 2 or sells it by December 31 in Year 1. The selling price less the tax on profits on selling the shares, which is calculated as the difference between the proceeds of sale and the acquisition costs extrapolated in Year 1, must be equal to the value of the net dividend if keeping the shares discounted at the market rate of return (which, in this case, is equal to the standard rate of return) after tax. The latter is given (rounded off) by

$$\frac{1,201.25}{1.0 + 0.06(1 - 0.25)} = 1,149.52 .$$

The selling price P is determined, given the extrapolated acquisition costs of 1,045.00, using the equation

$$P - (P - 1,045.00) 0.25 = 1,149.52 .$$

Resolved by P , this gives

$$P = 1,184.36 .$$

The tax on the capital gain of 139.36 ($1,184.36 - 1,045.00$) is 34.84. If invested at the net market interest rate, the compounded income tax on the capital gain of $36.41 = 34.84 (1 + 0.045)$ is equal to the revenue from taxing the total dividend (line 19 in Table 16 of Example 8). The buyer does not obtain any income as the dividend at the end of year 2 of 1,237.66 (see line 9 in Table 16 to Example 8) equals the compounded acquisition costs of the shares ($1,237.66 = P * 1.045 = 1,184.36 * 1.045$). The buyer is not liable to any further tax, therefore. The buyer sees assets grow by 53.30 ($1,273.66 = P * 1,184.36$), which is equal to the rate of return on the capital invested at the net market interest rate of 4.5% ($53.30 = 1,184.36 * 0.045$).

The result is that the principle of correspondence is maintained. The seller pays tax on realised capital gains, and the buyer can reduce taxable income accordingly.

2.2.4.4 Conclusion: Determining Return Allowance at Shareholder Level

127. Having considered the economic, EC law and administrative aspects, determining the return allowance for shareholders by extrapolating the costs of acquiring shares in corporations at the net rate of return appears to be preferable (method 2). This is the only way of achieving the finance neutrality desired for marginal investment. Determining the tax-exempt return on capital at corporation level (method 1), on the other hand, results in tax being levied twice if shares are disposed of. The requirements of EC law and some administrative requirements in terms of taxation are also better met by dealing with matters at shareholder level than at corporation level. On the other hand, this leaves the problem that determining extrapolated acquisition costs annually as the basis for the return allowance on dividends imposes ongoing recording and settlement obligations on shareholders, their asset managers or advisers.

2.2.5 Establishing and Extrapolating the Initial Value of Shares and Determining the Return Allowance

128. The legislative changes outlined mean initial values (market or historical values) have to be established for all holdings in corporations since introducing a dual income tax as we propose here indicates that – as far as Germany is concerned – all profits on disposing of shares in corporations will be taxable, in principle, for the first time. It also means ensuring that dividends and capital gains are

tax-exempt up to the value of the return allowance. Introducing dual income tax, therefore, implies that we have to establish an initial return base that is the value of the shares concerned for tax purposes, and procedures for extrapolating those share values.

2.2.5.1 Establishing Share Values for Tax Purposes (Return Base)

129. When it comes to determining the initial *return base* and *share values for tax purposes*, there are two options: We can either use their historical acquisition costs (Option 1) or re-determine their acquisition costs at the time the dual income tax is introduced for that purpose (Option 2). One argument in favour of option 1 is that payments actually made are used as the basis for the standard rate of return. Option 2 has in its favour that the values at the time the new tax system is introduced ought to be comparable (market values at the time dual income tax is introduced).

130. If we use the *historical acquisition costs* of shares, the problem evolves that the random factors at the time shares were acquired play a part in determining the return base and the return allowance. In the run-up to the law, we can also expect taxpayers to use buying and selling shares to realise capital gains and to increase acquisition costs on the one hand to avoid tax liabilities on the capital gains created in the past on shares which were not taxable before and to enjoy a higher return base on the other hand. Using the market value of share values removes this incentive while, at the same time, ensuring when shareholders dispose of shares in the future that the capital gains generated before dual income tax was introduced are not taxed. In addition to that this allays *constitutional law concerns* that capital gains having been accrued tax-exempt will be *taxed, retrospectively*. Correspondingly, this means the market value must be used even if it is less than historical acquisition cost.

131. This means that share values must be taken at their market value as of January 1 in the year of the changeover for all shares in corporations that *were not taxable before*. With regard to existing German tax laws, this includes private shareholders holding less than 1% in a corporation, provided they have held the shares for at least one year. Market values can also be established based on the known standards of the valuation tax act (§ 11 VTA): Publicly quoted shares can be valued based on their market price or quoted value at the time the changeover was made; non-publicly quoted shares can be valued at their market value using the so-called Stuttgart method, which is a special German tax valuation method for shares at that time. Where *shares are liable to tax*, that is shares in businesses (§§ 15, 16 ITA) and shares included in private assets which fall within the scope of §§ 17, 23 ITA,³⁰ and shares created by way of contribution (§ 21 RTA, they

³⁰ With regard to taxable capital gains from privately held shares, German tax law distinguishes between shares from substantial holdings (i.e. a shareholding of at least 1%, § 17 ITA) and capital gains from speculative short-swing transactions (i.e. a

must be valued at their *historical acquisition costs*. For reasons of simplification, taxable shares for the purposes of speculative short-swing transactions (§ 23 ITA) could also be valued at their market value as of January 1 in the year the change-over was made.

2.2.5.2 Extrapolating Share Values for Tax Purposes (Return Base)

132. Equity contributions and equity withdrawals have an impact on acquisition costs and the book value of shares, respectively – as is already the case under the law as it stands – which affects – under the proposed dual income tax – the *return base*. These changes can be monitored on a daily basis. The book value varies as follows:

Acquisition costs/book value (return base) at the start of the year (opening balance)
+ Equity contributions (open or hidden)
– Equity withdrawals
= Acquisition costs/book value (return base) at the end of the year (closing balance).

133. To simplify levying taxes, the return base could be determined less frequently such as quarterly or half-yearly. Tax as a whole, however, must be calculated *precisely on the day* although only if dividends are actually paid or shares are disposed of.

134. If a general capital gains tax is introduced, the data required is available and the systems for levying it are in place. This also includes regularly traded shares. *Custodian financial institutions* also hold the relevant information on acquisition costs and when shares were acquired as well as how long any given taxpayer has held them for shares which are traded on the stock markets.

135. Where shares are *not publicly quoted*, they are sold much less often but also attract dividends (e.g., out of reserves over a number of years) which means a return base has to be established. The fact that corporations are required to keep accounts is a great help in checking what the book value of holdings is in the light of withdrawals and contributions of capital at any time. In the final instance, this means there are no insuperable problems to determine the return base and the resulting return allowances at any given time.

shareholding of less than 1% and a disposal of these shares within 12 months after acquisition, § 23 ITA).

2.2.5.3 Determining the Return Allowance – Considered Globally or Individually?

136. The annual return allowance ('deductible return allowance') for dividends and capital gains is obtained by multiplying the return base by the standard rate of return after tax ('periodic return allowance') plus any return allowance not taken in the preceding assessment period:

Table 17. Determining the return allowance

Return allowance not offset from preceding period	
+ Acquisition costs/book value of shares	
= Return base for current period	
* Standard rate of return	
= Periodic return allowance	
+ Return allowance not offset from preceding period	
= Deductible return allowance	

As with return bases, return allowances must also be calculated *precisely on the day*. Return allowances are attached to the taxpayer but can 'run with the shares' if inherited or sold.

137. What is doubtful is whether return allowances should also be tied to individual shares from which they are derived. If we are serious about promoting investment neutrality and so wish to avoid 'penalising' *diversification strategies*, there are good reasons for taking all return allowances from shares at the end of the year to make part of the total dividends and capital gains or other capital income which has been subject to corporation tax tax-exempt. Any return allowances not used can, then, be carried over in time and in amount without restriction. Moreover, the return allowances carried forward are interest-bearing. They will reduce future dividends and capital gains or other capital income which has been subject to corporation tax. Using return allowances within a year and carrying over unused return allowances would ensure that *no return allowances are lost*. This, in turn, would exempt the standard rate of return on all equity capital invested in shares in corporations from income tax.

138. The mutual netting out of return allowances and capital income which has been subject to corporation tax as presented above, above and beyond individual holdings, proves to be highly problematic, on the other hand, when applying it in practice to tax at source.

The only simple way of levying tax at source is if the financial institutions which are managing the assets involved at the time earnings are generated (dividends or capital gains) can derive the acquisition costs in each case, assess the return allowances and take into account any return allowances already taken up (e.g., by way of dividends). Only then can the financial institution precisely calculate how much it should deduct and forward at the time tax is levied at source. The only way of practically doing this in administrative terms is to *base the return allowance on individual investments*. Since it is not until the end of the year that financial institutions have all the data for their portfolios they need to calculate the total return allowance on those portfolios and set it off against dividends and capital gains. But by that time, it is too late to levy the tax on source which has to be already deducted and forwarded when earnings are transferred during the financial year.

139. To avoid the problems stated with freely offsetting unclaimed return allowances on the one hand while maintaining the neutrality that is characteristic of the dual income tax model on the other hand as far as possible, we would suggest that any unclaimed return allowances are tied to the holding concerned. If shares are sold, any unclaimed return allowances will be lost. On the other hand, consideration could be given to extending the pool model familiar to accrued interest under § 43a ITA to enable unclaimed return allowances to be set off against other pre-taxed capital gains via tax at source if shares are sold.

140. Let us take an example to show how holding of shares is taxed, calculating the return allowances precisely to the day, if the return allowances are *tied to individual shares* (Table 18).

Example 10: The return for each share transaction is determined precisely to the day [interest rate per day = $0.0123\% = 6\% (1 - 0.25)/365$]. For Holding 1, which cost 100 units to acquire, this gives a return allowance of 4.5. Holding 2, which cost 200 units, is held for 130 days, giving a return allowance of 3.21 ($200 * 130 * 0.045/365$); selling holdings which cost 150 units to acquire leaves a portfolio of 50 units on which interest must be calculated for a further 235 days, giving a return allowance of 1.45 ($50 * 235 * 0.045/365$).

The return allowance on Holding 1 reduces the dividend; the remaining return allowance of 1.50 ($4.50 - 3.00$) can be carried over to the following year, earning interest accordingly. The return allowance for Holding 2 of 3.21 can be set against the capital gains in full leaving a return allowance tied to the balance of Holding 2 of 1.45, which can be carried over to the following year and earn interest accordingly. The return allowance for Holding 3 of 1.29 cannot be used as Holding 3 is disposed of and is, therefore, lost. The return allowance for Holding 4 of 8.69 can be set off against the dividends and capital gains in full.

Tying return allowances to individual investments means taxation is always final, making collecting tax much easier. It does not, therefore, compel taxpayers to make regular assessments, so that an important advantage of levying proportional tax at source as proposed here is retained.

Table 18. Example: Calculating return allowances precisely to the day

	1	90	130	300	365
	Days				
Holding 1 (a)					
(1a) Bought (+)/sold (-)	+ 100	.	.	.	.
(2a) Dividend	3
(3a) Capital gain
(4a) Return allowance	4.50
Holding 2 (b)					
(1b) Bought (+)/sold (-)	+ 200	.	- 150	.	.
(2b) Dividend
(3b) Capital gain	.	.	10	.	.
(4b) Return allowance	.	.	3.21	.	1.45
Holding 3 (c)					
(1c) Bought (+)/sold (-)	.	+ 50	.	- 50	.
(2c) Dividend
(3c) Capital gain	.	.	.	- 10	.
(4c) Return allowance	.	.	.	1.29	.
Holding 4 (d)					
(1d) Bought (+)/sold (-)	.	.	+ 300	.	- 200
(2d) Dividend	10
(3d) Capital gain	20
(4d) Return allowance	8.69

2.2.6 Treating Losses on Disposing of Shares in Corporations (Capital Losses)

141. Under dual income tax, individuals subject to unlimited tax liability will be liable to capital income tax at the proportional rate of 25% on capital gains from the disposal of shares in German and foreign corporations, where they exceed the return allowance. This applies irrespective of whether those shares are held in German business assets or privately. The holding periods and quotas used as standard for shares under §§ 17, 23 ITA to date are irrelevant.

The tax *principle of correspondence* means that losses on disposing of shares (i.e. capital losses) in German and foreign corporations would be subject to corresponding relief, that is at the level of proportional tax on capital gains. Setting off losses against progressively taxed earned income would only be provided for on a secondary basis, however. If *shares in corporations are disposed of at a loss* because the proceeds of selling the holding are less than its book value, such capital

losses can be netted *within the same period* against taxable dividends, capital gains and other taxable capital income (such as interest) in the same assessment period. Any capital losses that cannot be offset can be deducted via *inter-period loss set-off* against capital gains or other taxable capital income from future assessment periods. Setting off capital losses against capital income in the first instance ensures that capital losses generate tax savings at the 25% rate.

142. Should a capital loss coincide with unused return allowances from extrapolating the share value, this does not affect how much of the capital loss is deductible for tax purposes. The capital loss on disposal can be netted or deducted as outlined above. The return allowance, on the other hand, is tied to the holding disposed of and, hence, is lost.

Example 11: At the start of Year 1, a taxpayer invests 1,000 units in shares in Corporation D. With the capital invested, D makes a profit of precisely the standard rate of return of 6% (60 units); on this, it pays 15 units in corporation tax giving it an equity capital of 1,045. At the end of Year 1, D's shares stand at a market value (current value) of 945. When considering disposing of the shares at the end of Year 1, the shareholder wonders whether he should distribute D's profits as dividends first (option 1) or not (option 2).

The shareholder's return allowance is 45 units ($1,000 * 0.045$); his income from the holding before tax is tax-exempt to that extent. If he disposes of the shares in Corporation D at the end of Year 1 for 945 units (option 2), he loses 55 units on the deal ($1,000 - 945$): He can offset this against taxable capital income in future saving 13.75 units ($55 * 0.25$) in tax. The unused return allowance is lost. The shareholder's total liquid funds are now 958.75 units ($945 + 13.75$). If the open reserves of 45 units are distributed before the shares are disposed of, on the other hand (option 1), the dividends can be taken without having to pay tax on them by netting them against the return allowance. The share price falls to 900, and the shareholder makes a loss on disposing of them of 100 units ($1,000 - 900$), which can be set off against taxable capital income leaving the shareholder with liquid funds of 970 ($900 + 45 + 25$).

The result of this is, therefore, that dividends (option 1 in the example above) are treated more favourably than disposing of shares (option 2). This would not be the case if the return allowance were not lost when the shares were disposed of; in the example above, this would give additional tax savings of 11.25 ($45 * 0.25$) leaving the shareholder with 970 units in cash whether he sold the shares or took the dividends ($958.75 + 11.25$). Losing unused return allowances when disposing of shares would, therefore, have adverse effects in itself since it would influence corporations' dividends policies for tax purposes; but these effects must be accepted because tying return allowances strictly to individual holdings is essential for administrative reasons.

2.3 Contracts Between Corporations and Shareholders

2.3.1 Assessing the Adequacy of Performance and Consideration

143. Under dual income tax, there may be a considerable spread between the 25% tax rate proposed for corporations, which includes corporation tax, the solidarity surcharge and trade tax if applicable, and the rate of personal income tax including the solidarity surcharge on earnings income. This is 25% for those not paying income tax and 19.31% (44.31% - 25%) for those paying the top rate of income tax. The difference between these rates might encourage corporations to devolve their income onto their shareholders or, conversely, from shareholders onto their companies by concluding contracts on unreasonable terms different from those which would be used between independent third parties.

144. If these contractual agreements between corporations and shareholders include payment terms which are unreasonable, these can be corrected using the conventional tools of hidden profit and hidden equity contributions. Secondly, the single, proportional rate of tax proposed under the dual income tax system on amounts up to the standard rate of return on capital earned inside and outside businesses would nip such endeavors in the bud.

145. So the difference in tax rates offers little incentives for a corporation to offload its profits onto its shareholders. If shareholders lend a corporation money at unreasonable interest rates, any savings the corporation makes on corporation tax will be made up for by capital income tax. If the salaries managing shareholders are paid are unreasonably high, this will save on corporation tax; but under the progressive rate of income tax income tax on income earnings would be due which would normally outweigh any savings.

Example 12: At the start of Year 1, Managing Shareholder G invests 1,000 units in corporation D. With the capital injected, D makes a profit of 250 units before tax and paying its managers. A reasonable manager's remuneration would be 100 units, so D is liable to pay tax on 150 (250 - 100) units and pays 37.5 (150 * 0.25) units corporation tax. The profits after corporation tax at the end of Year 1 of 112.5 (150 - 37.5) units are paid out to G by way of dividends in full. G has a return allowance on the holding of 45 units (1000 * 0.045), giving a taxable dividend of 67.5 (112.5 - 45) on which capital income tax is due of 16.88 (67.50 * 0.25). The reasonable manager's remuneration attracts income tax on earnings income of 44.31 units (100 * 0.4431) leaving G with a net income of 151.31 (112.5 - 16.88 + 100 - 44.31). If the corporation decides to increase his manager's remuneration by 90 units to 190, D must pay tax on 60 units (250 - 190) and pays 15 (60 * 0.25) units corporation tax. If all the profits after corporation tax of 45 (60 - 15) units are paid to G as dividends at the end of Year 1, G does not have to pay tax up to the same amount thanks to the return allowance. On his manager's remuneration of 190 units, he has to pay in-

come tax on earnings income of 84.19 ($190 * 0.4431$) units giving him a net income of 150.81 ($45 + 190 - 84.19$).

146. In principle, under dual income tax, devolving profits from corporations onto shareholders would become less important. At the same time, however, there may be incentives to make excessive payments in exceptional cases. In such cases, payments can still be corrected using the provisions for *hidden profit distributions*.

147. Because of the uniform tax rate on profits up to the standard rate of return, it would also be pointless under a dual income tax system to devolve income onto a corporation by granting benefits under contract. Transferring fixed assets which make a profit equal to the standard rate of return to a corporation at below market price would not have any tax benefits, however. Some kind of reasonability check is still required to detect capital gains at the time they are transferred to the corporation. As with current law, these checks would be carried using the tool of *hidden equity contributions*.

148. Nor does the difference in tax rates offer any incentive, in principle, to shareholders to devolve their higher taxed earnings income onto their corporation. If a shareholder agrees on a payment that is unreasonably low, they are giving the other shareholders an advantage: The conflict of interests between shareholders is liable to limit such agreements. And even if there is no conflict of interest between the shareholders, the tax savings which could be achieved are likely to be low. If an unreasonably low payment is agreed, on the other hand (such as between a one-person corporation and its sole shareholder, for example), the shareholder will enjoy a liquidity benefit in the first instance to the value of the income tax on earnings income saved. On the other hand, the corporation will have to pay corporation tax on its now increased profits, and – since no return allowance is available since the acquisition costs of the shares are not affected – the dividends it pays will be subject to income tax. If the corporation invests its additional profits at the prevailing market interest rate, it has no advantage over a shareholder investing the payments they receive likewise at the market interest rate; either way, the interest income will be taxed at 25%. This means the shareholders cannot boost their assets by making a payment unreasonably low. Example 13 shows how little incentive there is to devolve income from shareholders to corporations under dual income tax.

Example 13: A shareholder reduces the salary he draws for managing a corporation by 100,000 units increasing the corporation's profits by that amount. It has to pay 25,000 units in corporation tax. Paying the tax leaves the corporation with 75,000 units, which it invests in the capital market at 6% before tax (net rate of return 4.5%) for 10 years and later distributes the amount it invested plus interest of 116,473 units ($75,000 * 1.04510$) as dividends. The dividends attract tax at 25%,³¹ leaving 87,355 ($116,473 - 116,473 * 0.25$). If shareholders are

³¹ Dividends count as taxable additional earnings income, irrespective of whether the return allowance is based on the corporation's equity capital as per its accounts

paid a reasonable salary, on the other hand, the corporation does not have to pay any more corporation tax, but income tax is due. At a tax rate of 43.75%,³² this leaves 56,250 ($100,000 - 100,000 * 0.4375$) after tax. This can be reinvested at the net rate of return of 4.5% for 10 years, which, again, gives 87,355 units ($56,250 * 1.04510$).

149. Seen from this perspective, there is no urgent need to correct unreasonably low payments a corporation makes for contractual liabilities to its shareholders. Paying less tax on earnings income than tax on dividends makes an unreasonably low payment unattractive in tax terms.

150. The situation would be different if interest income other than from businesses could not benefit from the low rate of tax on the standard rate of return on capital. In that case, there would be an incentive to shift profits from shareholders to corporations for tax purposes as Example 14 shows.

Example 14: Unlike in Example 13, we assume that a shareholder is paid a reasonable salary, and interest income from investing surplus payments is taxed at a rate of 43.75%. The amount after tax of 56,250 units ($100,000 - 100,000 * 0.4375$, see Example 13) can only be invested at a net interest rate of 3.375% ($6% * [1 - 0.4375]$) for 10 years. After that time, this gives the sum of 78,393 units ($56,250 * 1.0337510$). This is 8,962 units, or 10.26%, less than the 87,355 that could be obtained by shifting profits onto the corporation.

151. Even under dual income tax, however, if income tax rates and, hence, taxable income are high, devolving profits onto corporations is worthwhile for tax purposes. The marginal rate of tax must specifically be higher than the tax rate on profits in excess of the standard return on equity capital of 43.75%. This still leaves the liquidity effect if corporations reinvest their profits in investments which make more than the standard rate of return on capital. This means the respective profits are only taxed at 25% in the first instance. Shareholders in corporations could, therefore, reduce the tax burden on the proportion of their income which is taxed at more than 25%.

152. An unreasonably low salary represents a benefit which the German Supreme Tax Court case law has held does not qualify as hidden equity contribu-

(method 1, section 114) or on the costs of acquiring the shares (method 2, section 115). With method 1, financial assets are not included in the relevant equity capital base (see section 247 pp. on return on equity capital for transparent entities, which should apply to corporations with method 1 analogously); with method 2 as proposed here, reinvesting profits does not generally result in increasing acquisition costs (return base).

³² Assuming salary payments are subject to the top rate of income tax including solidarity surcharge at 44.31%, waiving salary is beneficial in tax terms although the incentives given by the income tax rate are on the low side (see Example 5 and Table 5 in section 62).

tion.³³ Therefore, such benefits do not increase acquisition costs of shares and, thus, the return base in the event of dual income tax. So there is no question of any tax correction. This is not an option that is open to partners in partnerships (or sole traders). This is one argument in favour of making checks as regards the appropriateness in amount. This could be an opportunity of establishing the specific rule in § 1 of the Foreign Transactions Tax Act,³⁴ which no longer stands up under EC law in any case as a general tax rule while at the same time enabling to make the law consistent in terms of both facts and consequences in law on a statutory basis.

2.3.2 Debt Finance

2.3.2.1 Fixed-Interest Debt Payments

153. The interest corporations pay on loans are deductible operating costs, thus, deducting interest reduces corporation tax by 25% of the value of that interest. The person receiving that interest is liable to capital income tax on it at 25%. Shareholders who allow unreasonably high interest on loans can be dealt with using the tool of hidden profit distributions (section 146).

154. Profits on disposals of receivables of any kind are also taxable. The distinction between interest earnings and return capital flow under income tax law as it stands does not apply here. The increase in net assets is taxed here as well. Taxing the proceeds from disposals of receivables overcomes any existing differences which cannot be justified on systems grounds in terms of taxing holdings and receivables in business assets. Broadening the tax base also serves to simplify calculating and levying tax. Any incentives to design financial instruments that convert financial interest to non-taxable capital flows disappear completely. Where financial institutions levy tax here, they have the information they need to hand. In the rather seldom cases where individuals obtain such profits directly, this means introducing mandatory recording obligations, accordingly.

2.3.2.2 Profit-based Debt Payments

155. One special problem is ‘hybrid forms of finance’ and, in particular, advancing debt against sharing in the profits, as is practised in form of so-called silent partnerships³⁵ or profit-linked loans. The profit-based payment for such debt

³³ BFH 26.10.1987 - GrS 2/86, BStBl II 1988, 348.

³⁴ BFH 21.6.2001 - B I 141/00, BFHE 195, 398; ECJ 21.11.02, case C-436/00, Coll. 2002, I-10829.

³⁵ A silent partnership organised under German civil law and recognised for tax purposes is a participation in the trade or business of another natural or juridical person constituting an association which is not outwardly apparent to the public and which

may easily exceed the value of the standard rate of return on the capital employed. If one were to allow payments on profit-based debt to be deducted in full – as is currently the case – while only subjecting the recipient to a proportional tax on capital income at 25%, this would considerably reduce the tax burden since, in that case, that component of the payments over and above the standard rate of return on capital would only be subject to tax at 25%, taking borrower and lender together. On the other hand, profit-based payments of all kinds – as the example of ‘usufruct’ in the current § 8 para. 3 cl. 2 CTA shows – could also conceivably be *fully equated with ordinary dividends*. This rule can also be generalised: Where profit-based interest is granted in return for providing debt wholly or in part, interest can be made non-deductible, not only with usufruct but also with (typical) silent partnerships or profit-linked loans. Interest payments, therefore, are subject to corporation tax. They are then taxed on the same footing as dividends. Lenders are treated in terms of their debt just like equity investors: The costs of acquiring usufruct, loan receivables and silent partnerships are extrapolated at the same rate of interest as applies to shares in corporations.³⁶ Profits on disposals are liable to tax accordingly. The only *special case is atypical silent partnerships*, which should be subject to the rules for transparent entities on account of their structural similarity with limited partnerships (see section 195 onwards).

156. If German legislators decide to make all financial instruments which involve a return based on profits non-deductible, this would also have consequences when it comes to classifying corresponding incoming payments from abroad. If silent partnerships are still classified as equity capital for tax purposes, for example, corporations in Germany could still largely receive such payments tax-exempt. Where operating costs are deductible abroad, this avoids return on capital being taxed in Germany in the first instance. Conversely, not all German double taxation treaties provide for such profit-based payments to be taxable in Germany. ‘One-stop taxation’, therefore, should be assured via continuing development of double taxation treaties. A more stringent measure which may have to be resorted to in order to prevent ‘creative accounting’ is to make such profit-based payments taxable unilaterally, but this would be in breach of existing international tax treaties.

2.3.3 Structures to Increase the Return Base

157. Given that profits on disposals of shares in corporations are generally liable to tax, proving that the costs of acquiring those shares were high would be beneficial for tax purposes. High acquisition costs are also advantageous, as they provide the basis on which the return allowance is calculated. This means that individuals can be expected to try to create structures which are aimed at increasing

does not have capital on its own. Profits paid to the silent partners are expenses deductible at corporation level and taxed as interest income the partner level.

³⁶ Thus, § 8a para. 1 cl. 1 no. 1 CTA would be pointless.

the costs of acquiring shares.³⁷ As a general rule, such structures are only worthwhile if shares can be sold tax-exempt and re-acquired tax-exempt.

158. This means that individuals with scattered holdings can be expected to restructure their holdings in corporations if making capital gains taxable in general and giving the opportunity of using a return allowance. On the other hand, the wind can be taken out of their sales if they have non-taxable shares at the time of switching to the dual income tax by granting a step up of acquisition costs (tax-neutrally) and, hence, making the return base based on market values (section 129 pp.).

159. In the long term, however, even if dual income tax is introduced, German corporations will still be able to sell shares to their shareholders (if they are individuals) tax-exempt.³⁸ We may, therefore, expect holding chains to be shortened, as Example 15 shows.

Example 15: Corporation C1 holds 100% of the shares in Corporation C2. X, an individual, holds all shares in C1. X now acquires the shares in C2 increasing their book value: Thus, X can now take more of C2's profits tax-exempt.

160. Where the shares in a German corporation are held by a foreign corporation that can sell those shares tax-exempt, those shares could once again be conceivably transferred to German individuals. Here, too, such a transaction could be aimed at increasing the acquisition costs of the shares and, thus, the return allowance. They could be invested in the foreign corporation in return for being granted shareholder rights.

Example 16: Foreign Holding Company H, a corporation, holds all the shares in German Corporation C. X, an individual, holds all the shares in H. H sells its shares in C to X tax-exempt for as high a price as possible. X can either hold the shares in C or reinvest them in H, for which he would get correspondingly highly valued shares in H. X can then enjoy the benefits of the higher acquisition costs, irrespective of whether he takes the profits directly from C or indirectly via H.

161. On the other hand, the point to remember with such structures is that, while profits on disposal may be taxable to start with, they are subject to income tax when distributed as dividends. Thus, handing the purchase price over to the corporation comes at the price of being liable to income tax at a later date. This applies to both profits obtained in Germany and abroad.

³⁷ Within groups of companies, however, such tax structures are not to be expected in response to dual income tax since no changes are proposed of taxing profits on capital gains or dividends, leaving the corporation tax holding privilege in § 8b CTA (section 94 pp.).

³⁸ The existing tax liability at 5% of capital gains under § 8b para. 3 CTA is to be dropped (section 95).

Example 17: Consider the chain of holdings from Example 15 ($X - C1 - C2$) assuming for the sake of simplicity that the book value of all holdings is zero. $C2$ has hidden reserves of 100 units, which have grown one year later to 104.5 at the net rate of return of 4.5%. X pays $C1$ the cash value of the expected dividend of $104.5 * (1 - 0.25)/(1 + 0.045) = 75$. The cost of acquiring the holding one year later is $75 * (1 + 0.045) = 78.38$. At the same time, however, $C1$ acquires liquid funds of 75 units. One year later, these have grown to $75 * (1 + 0.045) = 78.38$. If $C1$ pays a dividend, X is left with the net amount, $78.38 * (1 - 0.25) = 58.78$. $C2$'s dividend of 78.38 [= $104.5 * (1 - 0.25)$] is tax-exempt. In total, X receives $78.38 + 58.78$. If X had not created this structure, his liquid funds would have grown to $75 * (1 + 0.045) = 78.38$; if the hidden reserve had been distributed, he would have had a net dividend of $104.5 * (1 - 0.25) * (1 - 0.25) = 58.78$. Thus, there is no profit to be made by increasing the book value.

162. There is no point here in increasing the book value when acquiring shares in a corporation because it is bought by transferring funds to the corporation which are subject to income tax when they return later. The taxpayer is, thus, trading saving on income tax by increasing the acquisition costs of shares against paying more income tax on higher dividends from the corporation selling that shares at a later date. Assuming a uniform net rate of return, there is no point in increasing the book value to set the purchase price as high as possible, insofar as this is possible in the light of reasonability checks for tax purposes (in this case, hidden capital contribution). All that happens is that the corporation selling the shares receives more funds, which are taxed at a later date. The book value of the shares acquired may rise but the income tax saved by this is made up for by the additional income tax due when distributing the purchase price.

163. Should the actual rate of return vary from the standard rate of return which governs the return allowance, on the other hand, this has tax implications. Increasing the book value is worthwhile, provided the actual rate of return which can be obtained is less than the standard rate of return. If differences in rates of return mean increasing the book value is worthwhile, the amount of the purchase price also affects how much tax is saved. Shares could be valued excessively, as they in particular are open to some room to maneuver in terms of valuing them.

164. Increasing the book value is easily brought about between closely related persons, especially if corporations are involved; therefore, one might consider prohibiting increasing book values in transactions between closely related parties as a general rule. Such a far-reaching abuse rule seems disproportionately strict, however, and would, in many cases, be contrary to the principle that transactions between closely related parties are subject to the arm's length principle, which leaves the arm's length principle as the only option here. To avoid the vagueness which is inherent in valuations in particular, on the other hand, a specific valuation method (like, for Germany the so-called Stuttgart method, see section 131) could be used to determine the reasonable price for tax purposes.

165. The acquisition costs of shares of private individuals can be increased not only via share transactions but also via investing (whether openly or hidden) in the corporation. The only thing is that the profits on the assets invested would also be subject to corporation tax. The only worthwhile course of action, therefore, might be to contribute non-earning assets, such as unused real estate, especially if they are invested out of private assets for tax purposes. Here again, however, one has to keep in mind that these assets become business assets, therefore, any potential capital gains are subject to corporation tax and, if dividends are paid, to income tax inasmuch as they exceed the return allowance.

166. The equity contribution might conceivably be obtained via funds which the corporation provides to the shareholder by way of loan. The corporation granting the loan obtains an interest-bearing receivable, the shareholder has a debt on which interest is due, and the reinvested funds increase the acquisition costs of these shares. It follows that more dividends can be taken tax-exempt at a later date.

Example 18: Corporation A has financial assets of 100 units, earning a return of 6%. The dividend after tax is 4.5. If there is no return allowance and that dividend is subject to income tax at 25%, that leaves a net inflow of 3.38 units. A now transfers its financial funds of 100 units to its shareholder, X. This means that A now has a claim against X, which is subject to interest at 6%. X uses those funds to increase A's equity capital and, hence, the cost of acquiring the shares in A by 100 units. One year later, increasing the cost of acquiring the shares gives a return allowance of 4.5 units. Having concluded these transactions, A receives financial income of 12 units from the funds invested plus the receivable. A pays a dividend of 9 units after tax. X receives 9 units in dividends and pays 6 units in interest, leaving him with 3 units to be taxed on his own account. This income tax is based on the taxable component of the dividend of 4.5 units ($9 - 4.5$) less interest paid of 6 units, i.e. $- 1.5$ units, giving an income tax saving of 0.38 ($1.5 * 0.25$) leaving the shareholder with 3.38 ($3 + 0.38$). Thus, increasing the cost of acquiring the shares provides no benefit for tax purposes.

167. There are two conditions that must apply here for increasing the book value to have no effect: The rate of corporation tax must be equal to the rate of income tax on interest income, and the standard rate of return for tax purposes must be equal to the market rate of return. The second assumption is critical. If the actual nominal rate of return is less than the standard rate of return, using a loan to finance increasing the book value makes sense; the return allowance, which is calculated at a higher rate of return, protects dividends from higher taxation. If the reverse applies, increasing the book value would be to the taxpayer's detriment.

Example 19: Let us assume in Example 18, simplifying matters considerably, that the actual rates of return are zero. In that case the transaction merely increases the share's book value, so other dividends are protected against income tax accordingly.

168. Once again, this shows that monitoring contractual relationships between shareholders and corporations is extremely important. On the other hand, reasonability checks should make it possible to dismiss interest rates on loans to shareholders which are less than the standard rate of return as hidden profit distribution, as the standard rate of return for tax purposes represents an investment which is secure and largely risk-free.

3 Taxing Transparent Entities

3.1 Transparent Taxation Rather than Assimilation to Corporations

3.1.1 The Conventional Differentiation Between Transparent Entities and Corporations

169. Current German business tax law is based upon the principle that income derived from transparent entities (i.e. partnerships and sole proprietorships) should be attributed to and be taxed solely at the level of the individual owners (sole proprietorship) or partners (partnership) of the business for the purposes of income tax law whereas corporations are subject to a separate tax, namely corporation tax. What this means is that in the case of transparent entities profits are subject to tax immediately and entirely at the personal level whereas in the case of corporations – joint stock corporations in the first place – there are two processes to be kept apart: First, income earned by corporations is determined and taxed at company level; second, it is taxed again at the level of the shareholders on the dividends they receive. Any attempt to reform business tax law needs to start by reviewing whether these differences ought to be maintained and, if so, in what way, respectively.

170. For the purpose of determining the applicable regime, the statutory framework of business tax in Germany has traditionally followed the legal form in which the business is organised. The law is, thereby, largely guided by the distinction drawn within company law between legal persons on the one hand and natural persons and partnerships with jointly owned assets, respectively, on the other hand. This distinction is conventionally justified by assigning a specific ability-to-pay to legal persons on its own as to individuals and partner accordingly.

171. It is a commonly held attitude within legal doctrine that drawing distinctions in such a formalistic manner on law does necessarily generate tensions that are very difficult to handle when it comes to the wide range of possible structures available when designing businesses for civil law and financial purposes. For cor-

porations this range runs from the closely held one-person limited company (a German *GmbH* which is often recognised in business circles as a “sole proprietor with limited liability”) through to large publicly quoted joint stock corporations with portfolio shareholdings. In the law of non-incorporated businesses, they range from small service providers to long-standing family-owned limited partnerships with a limited company as general partner (*GmbH & Co. KG*) or investment-oriented real estate limited partnership (*KG = Kommanditgesellschaft*), thereby, equally offering a wide range of options.

172. So far tax legislation has not been unaware of these findings. More than once the borderline drawn that clearly by civil law according to the categories of legal capacity and asset ownership has been abandoned for tax reasons, such as when the German legislator decided to include certain associations to which legal capacity is not attributed by civil law into the scope of application of the corporation tax code or when classifying profits derived from the disposal of shares in corporations as “business income” in § 17 ITA. In civil law, on the other side, the conventional standards for differentiation have clearly experienced a development since the time when the legislator introduced the distinction between income tax and corporation tax in 1920. So the “unbridgeable conceptual divide” (*Otto von Gierke*) between corporations and partnerships was leveled off only most recently by Supreme Court case law recognising a (partial) legal capacity of partnerships.⁷⁷ Furthermore, a certain trend can be observed towards seeing corporatively designed publicly held partnerships more through the eyes of corporate law. Expressed in company law terms it can, thus, be said that the formal way of organisation takes more and more a back seat in favour of the association’s capacity to own assets.

173. Still, it must be emphasised that these developments mentioned above have not yet completely eliminated the differences in question. As the law and doctrine now stands, the crucial distinction – which is, not in the least, relevant for ability-to-tax considerations – between legal persons (and corporations in particular) and transparent entities is that, with partnerships, the partners are personally held responsible for business liabilities whilst this is not the case for corporations at all. With partnerships, this liability can only be limited with certain forms of organisation and even then only for individual partners.

3.1.2 The Demand for Neutral Business Taxation Regarding Legal Form

174. In the light of the developments within the field of private law as just outlined, the economic demand for a *business taxation that is neutral regarding legal form*, a subject which has been debated for at least 80 years now reappears on the agenda from a systematic point of view. After demands for a separate taxation of

⁷⁷ See Federal Supreme Court [BGH] judgment of 29.01.2001 - II ZR 331/00, BGHZ 146, 341.

retained profits were repeatedly raised and discussed since the Second World War, the idea of a tax system that does not discriminate against alternative legal form was most recently the task of a reform committee set up by the Federal Minister of Finance in 1998. This committee's findings were published as the "Brühl recommendations" and were integrated in the business tax reforms of 2001.⁷⁸

175. Until the mid-1980s, the question of legal form neutrality in Germany was largely covered (although with many individual nuances) by adjusting the top tax rates for corporation and income tax and allowing shareholders an imputation credit for the tax on the business profits distributed as dividends. Neither of these conditions now apply. Firstly, corporation tax rate was lowered from 56% to 25% in the course of just 15 years under the pressure of international tax competition, at the same time leaving income tax rates nearly unchanged. Secondly, not least due to requirements of EC law, the aim of integrating corporation tax into income tax was abandoned. Rather a half income method was introduced that results not only in a different total tax burden on profits of corporations (at both company and shareholder level) and partnerships but gave also rise to a difference in how profits retained and distributed are taxed.

176. A number of *alternative models* have been put forward in legal policy debates on how to find a solution for an appropriate tax treatment of businesses which is independent of the traditional distinction drawn by civil law between corporations and partnerships.

177. One model gives preference to a generalised business tax, thus, abolishing the given basic distinction between corporate and personal income tax. Such a uniform tax could be either applied to a business, its shareholders or partners. Ignoring the alternative of a single-level shareholder tax, which has now been generally recognised as impracticable, it proposes a *business tax concept* which stands out for the uniform approach to determine and to tax profits generated through business – and above all not withdrawn – at the level of the business itself.

178. Alternatively, one might consider redrawing the boundary between *corporation tax payers* on the one hand and (transparently taxed) partnerships on the other, such as transferring all jointly owned companies (or at any rate all limited partnerships or – even more narrowly – all limited partnership with a limited company as general partner, GmbH & Co. KG) to corporation tax law. Characteristic-based classification systems are also conceivable – as US law shows – based on organisational structure, number of shareholders, transferability of shares, or the liability position. The guiding principle would, then, be a classification system, depending on whether any given business was more personal or capital oriented, closely or publicly held. Given how complicated these criteria are, one could also discuss an option model where either all (or some) partnerships are offered voluntary access to corporation tax or even (along the lines of the US *check-the-box* me-

⁷⁸ See Tax Relief Act of 23/10/2000 BGBl I 2000, 1433.

thod) businesses of any kind are allowed to choose freely between the rules of corporation tax law and those of income tax law.

3.1.3 The Reform Process in Scandinavia

179. The alternatives as presented are also reflected in the discussions and law reforms which the Scandinavian countries experienced in the early 1990s in the course of introducing dual income tax systems. Here, too, the emphasis in business tax law was on the question of how to properly deal with small and medium-sized companies for tax purposes in an area where taxation based on legal form had resulted in unequal taxation.

180. Two models emerged in the Scandinavian debate as alternative reforms worthy of discussion: First, there was a ‘fence model’ which restricts preferential tax treatment to retained or reinvested profits; second, there was a ‘source model’, which divides a transparent entity’s profits by their ‘origin’ with a standard return on the capital employed on the one hand and an entrepreneurial reward on the other (which is taxed as labour income). There is no room to do more than outline either model here: They must each be seen in the context of the foregoing tax policy decision to tax corporations and the differentiations made there.⁷⁹

181. In the Scandinavian debate, the ‘source model’ triumphed over the ‘fence model’.⁸⁰ The argument against an across-the-board preferential treatment of retained profits was that drawing the boundary between capital income and labour income, especially at the margins between self-employed and wage earners (one can only think of ‘partners’ and ‘staff’ in professional partnerships), discriminated in favour of employees and against business people without any justification whatsoever. It was also said that the fence model favoured shifting investments from the private to the business sphere. Finally, favouring profits unilaterally reinvested in companies was said to generate problematic *lock-in* effects impeding an efficient resource allocation from a macroeconomic point of view.

182. On the other hand, the economic distinction between ‘entrepreneurial reward’ and ‘return on capital’ on which the source model was originally based proved to be open to abuse.⁸¹ The factual criteria which were originally laid down when asking whether shareholders were ‘employees’, which were based on certain

⁷⁹ The Norwegian system was roughly equivalent to transparent taxation of partnerships, for example, whereas Sweden retained the fence model, thereby, exempting an imputed rate of return on acquisition costs from tax; for an overview see Lindhe, Södersten and Öberg (2002: 579 pp.).

⁸⁰ See Hagen and Sørensen (1998: 43 pp.).

⁸¹ Compare the instructions to the government committee (*Skaugekommittee*) in Norway and its assessment of the potential for tax arbitrage; see Skatteutvalget (2003: 11, 235 pp.).

shareholding sizes or even on shareholders' minimum working hours, were difficult to administer and could easily be got around. These engagements in tax arbitrage resulted in the Norwegian legislators extending the fixed division of profits laid down in law underlying the source model to all types of businesses. In future, it is not about establishing a 'reasonable entrepreneurial reward': Instead the focus is on providing a preferential treatment for the standard return on the capital employed. Even this reform will fail to treat all forms of business equally, however; instead transparent taxation is to be retained for sole proprietorships.⁸²

3.1.4 Evaluation and Conclusions

3.1.4.1 Maintaining the Dualistic Approach to Business Taxation

183. The conceptual considerations as proposed in this opinion are based in the first instance on the fact that neither provisions of the financial constitution nor fundamental rights argue for or against a uniform system of business taxation. In terms of financial constitutional law, they are based on allocating revenue from income and corporation tax as 'joint taxes' to the Federation, federal states and local authorities under Art. 106 of the constitution. At any rate this makes it clear in terms of competence rules that the traditional dualistic approach of German business taxation is something the constitution recognises and accepts. On the other hand, it would also be possible to argue in favour of combining both kinds of tax for the purposes of taxing businesses and individuals consistently. The constitution leaves an extraordinary wide discretion to the legislator.

184. With regard to fundamental rights guarantees – such as the principle of equal taxation as laid down in Art. 3 para. 1 of the constitution – there is nothing to tie matters to any specific system. In taking their basic tax policy decisions, the legislators are largely at liberty, as constant case law of the Federal Constitutional Court (BVerfG) holds; they only become more restricted in terms of consistency when it comes to normatively differentiating the legislators' underlying system decisions. To what extent the civil law distinction between 'legal persons' on the one hand and 'natural persons' and partnerships on the other may be allowed to play a role has been inconsistently treated in Federal Constitutional Court case law: While older case law concluded from the particular civil law status of corporations that a distinction had to be made,⁸³ the Court has recently ruled that taxation discriminating against certain legal forms is unlawful in the field of VAT.⁸⁴ This still leaves the question as to what extent this finding, which seems persuasive when it comes to consumption taxes (where the emphasis is on whether consumers should be taxed), can also be extended to direct taxes. Lines of argument

⁸² This is the so-called *foretaksmodellen* [company model].

⁸³ See BVerfG, January 24, 1962 - 1 BvR 845/58, BVerfGE 13, 331.

⁸⁴ See BVerfG, November 10, 1999 - 2 BvR 2861/93, BVerfGE 101, 151.

put forward by some scholars attempting to deduce a restriction on tax policy from the freedom of association (Art. 9 para. 1 of the constitution) have not yet found any support in the Court's case law to date and have also been received with considerable skepticism in legal discourse.

185. No matter whether and, if so, to what extent the goal of legal form neutrality can be derived from Art. 3 para. 1 or Art. 9 para. 1 of the constitution, there can be no doubt that distinction by legal form may be possible, even compelling, where civil law distinctions have noticeable economic consequences and so have different consequences in terms of ability-to-pay considerations. When distinguishing between corporations and transparent entities, this particularly applies when it comes to *bearing losses and liability*. Whereas, with corporations (including exceptional cases liable to corporation tax such as associations without capacity in law), shareholders are only liable to bear losses or be liable towards third parties in single, exceptional cases, that liability and bearing of losses is the rule for transparent entities. This fully applies to sole proprietors, civil law partnerships and trading partnerships and also applies, with some distinctions in terms of persons, liability circumstances and quantitative limits, to the limited partnership and general partnership. There are some grey areas here: With any legal form, shareholders are at risk of losing their original investment, and personal liability can be varied more or less via individual agreements. But it is still acknowledged that, with transparent entities, personal liability is still the rule in law while this is not the case with corporations and associated bodies.

186. As with the history of business tax law to date, these legal distinctions continue to justify drawing a line between corporations (who are subject to the separation principle) and transparent entities whose profits and losses are attributed directly to individual owners (sole proprietorship) or partners (partnership) involved. This has major consequences, such as in applying the progressive income tax rate, waiving additional tax on dividends and/or withdrawals and on the possibility of netting losses between different sources or types of income.

187. Any attempt to oppose this continuing dualistic approach with ideas of a uniform business tax, on the other hand, is open to a wide range of objections. To justify such a uniform tax in civil law (and, hence, in business law), it is not enough to resort to a pretended independence of the 'business' or recognising that partnerships do have certain rights in law. In the first place, it is inconceivable that a business as such could either be seen as a legal person in the civil law sense or as drawing or consuming 'income' in the tax sense. A business is only ever an object, that is it is the source from which income is obtained and not as such accessible to being individually taxed in accordance with its financial ability to pay.

188. On the other hand, there would be problems in relying on partnerships as having a legal capacity on their own (and, hence, as being capable of having assets). In the final instance, that would merely shift the boundary between the two tax regimes without abolishing it in principle. The borderline would primarily run

between partnerships and sole proprietorships that do not have a separate ‘operating sphere’ as a conceivable taxpayer in law in any case. They are not some marginal phenomenon which can be ignored, in fact, as sole proprietorships are the most widespread form of all businesses in Germany, with 70%.⁸⁵

189. But it is not only sole proprietorships but also typical co-entrepreneurial undisclosed partnerships (such as the popular atypical silent partnership) that would have to be excluded from such a uniform taxation, as they lack any separate entity to which property rights may be attributed; the running of the business and specifically the assigning of assets rather rests on a pure contractual and personal basis. This would mean abandoning a useful principle of current tax law, namely the “equivalence of co-entrepreneurships with and without jointly held assets”. In the border areas between limited partnerships and silent partnerships new distinctions would be needed and new possibilities for arbitrage would be available.

190. The most convincing proposal would be to bring partnerships with partially limited liability (limited partnerships) under the rules of corporation tax law. On the other hand, this would inevitably cause problems in turn: Should general and limited partners be treated differently? Should there be special provisions only for limited partnership with a limited company as general partner (GmbH & Co. KG)? The simplification effects as originally intended do not do justice to the civil law and to financial differences between different holding and legal forms.

191. Whereas this means that, seen in normative terms, legal differences between legal forms do firmly argue against an equal treatment for tax purposes, from an economic standpoint the detrimental effects of giving sole proprietorships and partnerships personality in law in their own right are overwhelming. Subjecting such businesses to a uniform business tax would mean denying the entrepreneurs involved access to the basic allowance and lower entry level bracket rates for income tax and, what is even worse, making it consistently harder for them to set off losses against income from other sources. People’s readiness to take risks essentially depends on them being able to offset losses. Fencing losses largely into businesses would favour large businesses which have enough profits to cover losses from individual investments for tax purposes. On the contrary, smaller businesses and start-ups in particular facing considerable losses at the time of establishing would be disadvantaged.

192. Therefore, it is proposed that the ‘transparent’ taxation for business activity traditionally used for non-incorporated businesses as a whole be retained. Income derived from partnerships will continue to be attributed to their partners – along the lines of § 15 para. 1 S. 1 no. 2 ITA – ‘directly as their own’.

⁸⁵ In 2003, the total number of all enterprises together, irrespective of corporate form, was 2,915,482. Of these, 2,402,501 were non-incorporated businesses of which in turn 2,029,784 were sole proprietorships (Federal Statistical Office, 2003).

3.1.4.2 A Broad View of Business Activity

193. Should the dualistic approach to business taxation be maintained, one of the main questions which follow is how the scope of future business taxation should be defined under income tax law. The focus is on two sub-questions here: the definition of ‘business activity’ on the one hand and the distinction between capital income and other income (earned income) on the other hand.

194. If the question as to how to define ‘business activity’ is a hot topic, this is because there are currently three different versions co-existing side by side in German business tax law, which the politics has largely ignored. The widest scope of “business” rests with corporations. Under § 8 para. 2 CTA, any activity (or at least any activity directed at generating an income) qualifies as ‘business’. Of the list of the seven types of income under the income tax law, this, therefore, includes six as business: not only actual income from business itself but also income from agriculture and forestry, self-employment, rent and lease, capital assets and other income. Only income from employment is excluded, as a corporation cannot be employed by definition. As to transparent entities, on the other hand, the basic rule is that only true ‘businesses’ qualify for the tax rules for businesses: The only way other income components can come within the scope of these rules is via special rules (such as the ‘infection rule’ and ‘rule of preponderance’ in § 15 para. 3 ITA); plus ‘legal concepts’ developed through case law such as “separation of business” or “partner’s business assets”, which bring financial and real estate assets within the scope of income from business.

195. On looking more closely, we find that the definition of ‘business’ under the law as it stands (§ 15 para. 2 ITA) is full of shortcomings. While it makes sense to retain the criteria of independence, sustainability, profit orientation and market participation (to exclude income from employment but also mere performance of self-help services and occasional transactions), it is impossible to say why self-employment or agriculture and forestry, income from rent and lease and financial income should be removed on the grounds of a ‘negative characteristic’. This ‘negative demarcation’ can only be explained against the background of additional taxation with trade tax (which is itself scarcely justifiable from a system standpoint). If we consider that being liable to tax (but also being potentially eligible for favourable treatment in tax terms) should not depend on sophisticated differences between ‘pure’ and ‘commercial’ agriculture or between being a consultancy as a trade or as a liberal profession, we have to use a definition of ‘business’ which is extensive in scope. If we also consider that it is often up to persons acting as entrepreneurs whether they invest working assets as equity capital or provide them as debt (through rent and lease or by way of loans), it also becomes clear that designing the new business tax system must include the existing § 20, 21 ITA as well. This basic conception alone is also in line with the report’s intention of achieving a level of tax which is internationally competitive for all kinds of investments, irrespective of how they are financed.

3.1.4.3 No Favourable Treatment for Retained Profits

196. Having opted for this broad definition of ‘business’, the question arises of how and in what direction we are to favour business profits. The ‘fence model’ has a long tradition in the German reform debate, which provides preferential treatment for reinvested profits whereas distributed profits are liable to income tax in full and may even be subject to an additional tax on the pay-out. Given what is being proposed here, this model could also serve as a guide to taxing corporations, providing a consistently low tax rate on retained profits.

197. Linking tax reliefs with retained profits raises, however, serious practical problems, which have been discussed ever since the first attempts made in 1949.⁸⁶ These were evident again in the wake of the Brühl recommendations of 1999.⁸⁷ The points involved here are:

- *Keeping equity accounts:* If retained profits are to be favourably taxed while distributed profits are to be subsequently taxed a second time, this means that the equity in the company as well as in the partner’s additional balance sheets must be broken down. Profits reserves must be disclosed separately and must not be netted with contributions. This puts self-financing on a worse footing than creating equity capital through contributions. Having an order of precedence of use, whereby withdrawals would preferably be charged against the post-taxation account, would be an incentive to withdraw equity capital at first.
- *Additional and supplementary balance sheets* of the partners would have to be included when assessing profits to be favourably treated and brought under the withdrawal rules.
- *Shifting assets* between the partnership, the partner’s additional accounts and the partners’ own businesses would need (complex) regulation if exaggerated lock-in effects are to be avoided.
- In the case of multiple-layer partnerships a *consolidation* would be required in order to attribute the profits to the partners involved.
- *German partnerships’ activities abroad* must be treated on a non-discriminatory basis, within the European Union at least. What this particularly means in is that favourable tax treatment must also be extended to reinvesting profits abroad, and any withdrawals from foreign permanent establishments must be subject to subsequent taxation.
- *Favourable treatment:* As the Brühl recommendations already foresaw, sole proprietorships and partnerships cannot benefit from a favourable treatment of retained profits until their income amounts to around 50,000 euros, as small business people typically depend on distributing profits up to this range to cover their living costs.⁸⁸ This has been confirmed by finance statistics analysis

⁸⁶ A report to this effect along with draft laws on business tax were presented by the business tax committee of the tax authorities (Business tax committee of tax authorities, 1949: 931).

⁸⁷ See Brühl recommendations on reforming business taxation (1999).

⁸⁸ See Brühl recommendations on reforming business taxation (1999: 78).

- since. Then again, there is the fact that, to a sole proprietor, the benefit depends on the extent of the tax rate to be applied to retained profits (say 25%) that exceeds the current lower entry-level-bracket rate of 15%. Finally, any favourable treatment for tax purposes by reference to the partners' personal rates is theoretically impossible if retained profits are to be uniformly taxed.
- *Loss-offsetting* between partnerships and partners should be a major argument against special treatment for retained profits in partnerships and sole proprietorships. Because partners and sole proprietors are largely liable personally and have to bear losses personally, 'locking in' losses in partnerships, which would prevent them from being offset against income from other sources (and, conversely, would also prevent losses from other sources being offset against retained profits) must be dismissed as not compatible with the ability to pay-principle. Even if individual liability is excluded (as in the case of limited partners, for example) and this can be equated with holding shares in a corporation, where any loss of value is not realised until those shares are disposed of, applying such a solution to personally liable partners and sole proprietors would be fundamentally out of line with civil law and financial rules.

198. Taken as a whole, there are major arguments against a favourable taxation of retained profits in transparent entities.

3.1.4.4 Favouring Working Capital

199. On the other hand, what does appear reasonable and thoroughly viable is a split income model which distinguishes between capital income which are favourably treated and other income which is normally taxed (especially labour income) and, hence, is not based on the distinction of whether profits are distributed as dividends, withdrawn or retained. The first point to make clear here is that 'pure' labour income without any capital expenditure (income from paid employment) is subject to tax at the normal rate whereas 'pure' capital income, such as from interest-bearing investments, is all favourably treated for tax purposes. Income from rent and lease can either be subsumed under 'pure' capital income or treated as business income, as explained below.

200. What has to be regulated, of course, is the case of hybrid income, where income is obtained from a combination of employing labour and capital, which is typically found in running a consistent business. One possibility when designing a dual income tax would be to use 'labour income' as the starting point for separation and working out a 'reasonable entrepreneurial reward' for business income. This would be difficult to handle administratively and would be open to creative accounting and abuse by taxpayers. It would also mean to distinguish between more or less closely held businesses. To meet these concerns there has occurred a paradigm shift in thinking about dual income tax in recent times: As a general rule, preferentially taxed return on capital employed is used as the key element of the system while any profits going beyond that, whether they be classified as 'excess profits' or 'entrepreneurial reward', are taxed at the normal rate. This distinc-

tion not only increases legal certainty considerably; it is also in line with relieving marginal investment which is more important in economic terms.

201. The statutory provisions as proposed here are, therefore, based on the concept of taxing return on capital employed more favourably (at a lower rate of income tax), irrespective of the source of income or the legal form involved.

202. The result is a model which favours or relieves return on capital, not just for transparent entities in the conventional sense (understood as a 'commercial business') but on all capital, no matter how employed. The resulting relief effects on corporations have already been described in the previous chapter. The next step is easily done, i.e. to include the reward actually stipulated and paid for capital commitment entirely in the favoured scope of income from providing debt (interest and equivalent payments or capital gains). This could also be considered for payments for providing capital in kind (such as from renting and leasing of estates, moveable assets or intellectual property rights).

203. For commercial businesses, liberal professionals and agricultural and forestry enterprises, a legislative approach must be used which binds a reduced tax rate to a standard return on the capital employed ('return component'). Any profits going beyond that ('earnings component') are to be taxed at the normal rate without having to (or being able to) consider to what extent this additional income derives from 'labour income' in the strict sense, i.e. 'entrepreneurial reward' or from other factors, such as being well-positioned in the market or ahead in terms of technology.

204. There are considerable benefits involved here. The first is that this tax system provides finance neutrality. It does not make any difference whether a business is funded by equity or debt or whether the fixed assets are acquired or used under contract (rented or leased). The second benefit is that no distinction has to be made as to whether profits are retained or distributed, thus, there is no need to keep or monitor extensive investment accounts. The third benefit is that different asset and liability structures of transparent entities are immaterial and that there is no need to include other sophisticated distinctions, such as whether assets count as part of the partnership or partner's additional assets. All this leads to a wide-ranging, non-discriminatory preferential treatment of income from the capital employed.

3.2 Special Tax Treatment of Standard Return on Equity

3.2.1 Restriction to Businesses Preparing a Balance Sheet

205. In terms of income defined as profit, the ‘return on equity’ model presented has to deal with the plurality of methods of how profits can be measured. For technical reasons, it is advisable to restrict the scope of return on capital to businesses which calculate their profits following the accruals concept (i.e. businesses preparing a balance sheet) under § 4 para. 1 ITA (in conjunction with § 5 ITA): since this alone can give us the essential initial variable for the ‘capital’ on which a return is to be earned from the business’s accounts.

206. This means, in particular, excluding the set of self-employed and small businesses taxed on a cash flow basis under § 4 para. 3 ITA and, furthermore, agriculture and forestry enterprises which use average value taxation under § 13a ITA from the new rules. It should be remembered, however, that, even under the law as it stands, voluntarily keeping accounts allows them the option of calculating their profits in accordance with § 4 para. 1 ITA (or, in the case of small businesses, § 5 para. 1 ITA), thereby, drawing up a balance sheet and showing the relevant capital. On the other hand, with taxpayers who calculate their profits in accordance with § 4 para. 3 ITA on a cash flow basis, the capital they employ in obtaining an income is often so small that switching to the accrual method does not always pay off. For agricultural and forestry enterprises, finally, we should also remember that the existing ‘average taxation’ under § 13a ITA provides enormous relief, which does not need to be combined with a preferential taxation of the standard return on equity. Reform commissions have often strongly demanded that § 13a ITA is to be abolished not least because of doubts as to whether it is constitutional, but there appeared to be no way politicians would implement this. Offering to allow agricultural and forestry enterprises to voluntarily include themselves in the new business tax law (and, thus, to extend the benefits of splitting profits to this group) therefore seems appropriate, as it can only encourage the ‘exit’ over time from the doubtful regime of § 13a ITA.

3.2.2 Standardised or Actual Return?

207. The questions at the outset which the model of taxing capital employed at a preferential rate must answer include the topic as to whether and, if so, what income sources involve an actual (i.e. stipulated and paid) return on the capital employed and in which cases only a standard return is used. Initially, the answer appears simple: If we can identify clear indications in the legal and financial nature of a source of income of what the return on capital is and how much, we must use the actual amount. This is also in line with the ‘reality principle’ of taxation. Only if it is impossible, from agreements made and practiced, to determine to what ex-

tent income counts as ‘return on capital’, we will have to use a standard rate of return. The obvious option here (in the interests of neutrality with regard to legal form and financing) is to use the rate of return which was already used in the initial model for corporation profits (section 108 pp.).

208. This means that income from returns on debt is subject to the preferential rate of tax at their actual amount. The situation with business income is different: The only way of differentiating between the preferential return component and the earnings component which is taxed at the standard rate is to use a standard rate of return on the capital employed. This means we have to determine the equity capital employed in the business from accounting variables and apply a standard rate of return to that equity capital.

There is a problem, however: As debt interest is differently measured, depending on the individual debtor, and is also constantly fluctuating under the influence of the capital markets whereas determining the standard rate of return on capital employed in law must be formulated for a given period in time, the return on capital actually obtained in the market and the ‘fictive’ legal return will tend to drift apart. This is something which has to be considered when formulating the new business tax law.

3.2.3 Including the Partners’ Business Assets

209. If we base the preferential effects on the standard rate of return on the capital a business employs, business assets owned by the partners (and income obtained from them) can be seamlessly included in the preferential treatment argued here. There is no room here for a detailed discussion of the legal and conceptual basis for the inclusion of a partner’s assets into the balance sheet of the partnership. It has to do not only with the idea of equating sole proprietors and partners but also with the problem of how extraordinary operating profits are to be recorded for trade tax purposes and with the aim of taxing capital gains and accretions of those business assets.

210. These aspects are not of primary importance from the standpoint of dual income tax. What does appear important is the aspect of finance neutrality: If it should not make any difference in principle whether a business uses debt or equity but rather the payments for providing financial capital and capital in kind should equally be included in the field of new business taxation, then it is essential that transfers of use between the partners and the partnership itself should be recorded as such. This is where the concept in law of “special business assets” comes in, which is mainly designed to add the fixed assets assigned for use to the company’s equity capital ‘in principle’ and that of its partners as the basis for a preferentially treated return on equity capital. The alternative – that is, separating the items assigned off into a separate ‘company code’ of their own – on the other hand, would enable companies and shareholders to use a great deal of creative accounting between them.

3.2.4 Mezzanine Financing

211. A current issue within the field of business funding of major and growing importance is posed by mezzanine financing instruments which are widely used in practice but very difficult to address due to their ambiguous status between debt and equity. In general, mezzanine instruments are contracts which combine contribution of capital with profit-related or sales-dependent remuneration. They start with participating loans that are loan agreements for which the payment is atypically profit related. Very close to this are typical silent partnerships, where contributing capital goes hand in hand with an ordinary share of the operating profits (and which may also include sharing in losses or not, at the parties' discretion). This series continues with atypical silent partnerships, where the dormant partner acquires a share in the value of the company's hidden reserves. Another form of funding – especially in the case of corporations – are 'rights of jouissance', which grant the holder share-like asset rights in personam.

212. Current German tax law does not cope with these innovations in a satisfactory way. While proceeds from participating loans or silent partnerships are seen to simply generate capital yields for the beneficiary's part and business expenditures on the debtor's part, matters are differently arranged with other kinds of mezzanine instruments as in the case of an atypical silent partnership for example: Defined as a 'joint enterprise' (analogous to the limited partnership) profits are assessed "uniformly and separately" in such a way that the entire framework of rules on special business assets and the like applies. Payments on rights of jouissance, on the other hand (provided these rights entitle to a share in profits as well as future proceeds of liquidation), are not at all treated as deductible expenditures on the part of the company paying them but are considered equivalent to dividends.

213. For the new business tax law, the leading point to consider is the concept of 'finance neutrality'. Taxpayers should not stand to gain or lose any particular benefits or drawbacks from their choice of funding. On the other hand, as with the law as it stands, income earned by corporations will continue to be recorded for tax purposes at two levels while income of transparent entities is only taxed once.

214. What this means is, first, that a distinction must be made between (in personam) holdings in corporations and (in personam) holdings in transparent entities. If and insofar as a shareholder provides a corporation with capital on an in personam basis and receives a share of the profits in return, these profit-related payments must not be deductible as far as the corporation is concerned if finance neutrality is to apply: Very alike to the way dividends are dealt with, these payments must be rather counted as profits liable to corporation tax first and later recorded against the shareholders as dividends. Those provisions of German tax law currently applicable only for jouissance rights (§ 8 para. 3 clause 2 CTA) would be extended in scope for participation loans and typical silent partnerships (as already in § 8a CTA) whereas participation loans given to and silent partnerships es-

established with transparent entities would be covered by their specific tax regime, i.e. participation loan capital, contributions of a silent partner or jouissance capital would become part of the enterprise's capital as the starting point for determining the return component and the profit shares attaching to them preferentially treated for tax purposes at the standard rate of return. However, it has to be kept in mind that this approach would bring about the amendment of many double taxation treaties to readjust the distinction between dividends and interest.

215. This means that, unlike under the law as it stands, the only deductible expenditure would be interest on debt:⁸⁹ All profit-related payments would be part of business profits (and would be divided into a preferentially taxed return component and an earnings component taxed at the normal rate). This also ensures at the same time that profit-related payments do not generally come to enjoy the preferential treatment granted to return on equity capital in full.

216. Yet another approach could be used in the case of the atypical silent partnership. Regarding the in personam participation of the silent partner, this is very much like a 'virtual limited partnership' (*Karsten Schmidt*). To avoid any differences in taxation between the in rem designed limited partnership and its parallel structure in the law of obligations, the obvious choice would be to treat an atypical silent partnership like any other kind of partnership. Where there is an atypical silent partnership with a limited company (GmbH), the tax rules for a limited partnership with a limited company as general partner (GmbH & Co. KG) apply. In such cases, profits obtained from an atypical silent partnership come under the rules for transparent entities. This safeguards the well-founded principle of "treating all jointly-held businesses equally".

3.3 Taxing Business Profits

3.3.1 The Basic Concept of Profit Splitting

217. Following the concept of preferentially treating the standard return on equity capital, the implementation of the concept of dual income tax in the framework of transparent entities requires to split net profits into two separate components. A return is then to be calculated on the equity capital invested in the business (at the standard rate of return) in order to ensure that profits up to that amount are treated in accordance to a comparable investment in the capital market ('return component'). Thus, in setting the return component we must be guided by the nominal debt interest rate businesses face at the capital market. This has already been

⁸⁹ The situation is similar in the Netherlands, see Art. 10, para. 1, section d and para. 2 Law Vpb 1969.

explained in detail for corporations. In the next step, of the annual profits (calculated by adhering to the traditional profit measurement methods), we must then subject a return component to the preferential capital income tax rate; any profits in excess are eventually taxed at the given progressive income tax rate. Example 20 may illustrate how a transparent entity would be taxed if all profits are retained in Year 1 (Table 19).

Example 20: Take a partnership with an equity capital of 1,000 units; in all other respects, the assumptions involved are comparable to those used in Example 7. Pre-tax profits are divided into a return component and an earnings component: The former is taxed at the preferential rate for capital income of 25% while the earnings component is assumed to be taxed at 43.75%. The business is wound up at the end of Year 2.

Table 19. Dual income tax: Taxing sole proprietorships/partnerships

	Year 1	Year 2
(1) Equity capital (opening balance)	1,000	1,095.62
(2) Applicable return component $[0.06 * (1)]$	60	65.74
(3) Profit before income tax $[0.15 * (1)]$	150	164.34
Of which:		
(a) Return component to apply $\{\min[(2); (3)]\}$	60	65.74
(b) Earnings component $[(3) - (3a)]$	90	98.60
(4) Income tax $[(4a) + (4b)]$	54.38	59.58
Of which:		
(a) On return component $[0.25 * (3a)]$	15	16.44
(b) On earnings component $[0.4375 * (3b)]$	39.38	43.14
(5) Profit after income tax $[(3) - (4)]$	95.62	104.77
(6) Distribution	.	1,200.39
(7) Equity capital (closing balance) $[(1) + (5)]$	1,095.62	.

218. To ensure that the relief on the standard return on equity capital is not arbitrary, it is extremely important that the return on equity is consistently recorded over time. This means that, should the profits in any year fall short off the standard return on equity, it should be provided that this amount is carried forward and set off against future profits. This ensures that, when relieving the standard return on investment, it is not dependant on the assessment period in which earnings are actually realised. This can also cover the risk that expected profits do not occur justly in time.

Example 21: Let us now have a look at a partnership with considerably fluctuating profits. In the year of establishment (Year 1), its profits fall short of its standard return on equity. The part of its return on equity not ‘used’ may be carried forward to the following year (line 2), thereby increasing both next year’s return base (line 3) and the maximum (‘applicable’) return component (line 4). Without a carry-forward of the (cumulative) return on equity capital that has not been applied to profits, the tax burden in Year 2 and Year 3 would be unduly high. Our example assumes that the partnership generates a pre-tax return on equity of 6% in the course of a three-year period (Table 20). The procedure

involved here corresponds very much to the approach taken for the carry-over of unused return allowances provided to shareholders in Table 16.

Table 20. Dual income tax: Taxation of non-incorporated enterprises with carry-forward of non-applied capital components

	Year 1	Year 2	Year 3
(1) Equity capital (opening balance)	1,000	1,000	1,000
(2) Non-applied, carried forward return component	.	60	123.60
(3) Return base [(1) + (2)]	1,000	1,060	1,123.60
(4) Applicable return component [(2) + 0,06 * (3)]	60	123.60	191.02
(5) Pre-tax net-profit	0	0	191.02
Of which:			
(a) Applicable return component {min[(4); (5)]}	0	0	191.02
(b) Earnings component [(5) - (5a)]	0	0	0
(6) Income tax [(6a) + (6b)]	0	0	47.75
Of which:			
(a) On applicable return component [0.25 * (5a)]	0	0	47.75
(b) On earnings component [0.4375 * (5b)]	0	0	0
(7) After-tax profit [(5) - (6)]	0	0	143.26
(8) Non-applied return component to be carried forward [(4) - (5a)]	60	123.60	.
(9) Distribution	.	.	1,143.26
(10) Equity capital (closing balance) [(1) + (7) - (9)]	1,000	1,000	.

3.3.2 Comparison of Tax Burdens of Corporations and Transparent Entities

219. It might be appropriate at this point to give account of the quantitative differences in tax burden due to the dualistic approach to business tax law that taxes non-incorporated enterprises in a transparent manner but makes a difference between the spheres of business and investors when it comes to the taxation of corporations. The consequence of this dualistic approach becomes apparent in the specific case that a company yields a profit that considerably exceeds the standard return on equity capital that has been employed in the business. Whereas the earnings components of sole proprietors or partners are continuously taxed at the progressive rate of income tax, corporate profits, quite differently, independent of whether they exceed the standard return to equity or not are only subject to proportional corporation tax as long as they are retained and not distributed to the shareholders. When comparing the different forms of businesses transparent entities might be disadvantaged in terms of liquidity. Taxing earnings components earlier at a higher rate also reduces the capital available for further investment, so capital growth may be harder at any given pre-tax return.

By contrasting Tables 19 and 16 these effects are clearly disclosed. At the end of Year 2, the shareholder in the corporation has a post tax income of 1,201.25 units whereas the partner ends up with only 1,200.39 units under comparable conditions. The difference of 0.86 units (1,201.25 - 1,200.39) is due to the fact that the corporation has higher post-tax profits than the partnership at the end of the

first year. The corporation’s advantage amounts to 16.88 units (112.50 - 95.62). This additional profit could be reinvested at the rate of return on capital of 15% (that is above the market rate of 6%). The difference of 9% as compared to the market interest rate results in an additional profit of 1.52 (16.88 * 0.09): This amount is subject first to corporation tax at 25% and then on the shareholder’s level again at 25% income tax, thus, leaving 0.86 units after tax (1.52 * 0.75 * 0.75).

Table 21. Dual income tax: Tax burden of transparent entities and corporations – Profits reinvested at 6%

	Sole proprietorship/ partnership		Corporation	
	Year 1	Year 2	Year 1	Year 2
Company level				
(1) Equity capital (opening balance)	1,000	1,095.62	1,000	1,112.50
(2) Profit before tax	150	155.74	150	156.75
Of which:				
(a) Return component [0.06 * (1)]	60	65.74	.	.
(b) Earnings component [(2) - (2a)]	90	90	.	.
(3) Taxes at company level	54.38	55.81	37.50	39.19
Of which:				
(a) Corporation				
Corporation tax [0.25 * (2)]	.	.	37.50	39.19
(b) Non-incorporated enterprise				
Income tax on				
- Return component [0.25 * (2a)]	15	16.43	.	.
- Earnings component [0.4375 * (2b)]	39.38	39.38	.	.
(4) Profit after tax [(2) - (3)]	95.63	99.93	112.50	117.56
(5) Withdrawal/distribution	.	1,195.55	.	1,230.06
(6) Equity capital (closing balance) [(1) + (4) - (5)]	1,095.62	.	1,112.50	.
Shareholder level				
(7) Cost of acquiring/book value of the holding	.	.	1,000	1,000
(8) Carried forward, not applied return allowance	.	.	.	45
(9) Return base [(7) + (8)]	.	.	1,000	1,045
(10) Periodic return allowance [(1 - 0.25) * 0.06 * (9)]	.	.	45	47.03
(11) Dividends before income tax	.	.	0	1,230.06
(12) Tax-exempt dividends [(12a) + (12b)]	.	.	0	1,092.03
Of which:				
(a) Reimbursement	.	.	0	1,000
(b) Applicable return allowance {min[(10) + (8); (11)]}	.	.	0	92.03
(13) Taxable dividends [(11) - (12)]	.	.	0	138.03
(14) Income tax [0.25 * (13)]	.	.	0	34.51
(15) Non-applied return allowance to be carried forward {max[0; (10) + (8) - (11)]}	.	.	45	.
(16) Net revenue	.	1,195.55	0	1,195.55

220. The difference in taxation between transparent entities and corporations would vanish if the profits reinvested after tax yielded a return at exactly the prevailing market rate of 6% and not of 15% in accordance with the return on investments in kind (Table 21). In this case net dividends would be equal. It can, thus, be shown that, while differences in rates cause a difference in liquidity, they do not necessarily cause a difference in value. There are good economic reasons

for assuming two different interest rates as not all kinds of assets will earn returns at a rate as high as 15%.

Example 22: Table 21 modifies the assumptions in Tables 16 and 19 by investing the profits ploughed back in Year 1 of 95.62 units in the case of the transparent entity and 112.50 in the case of the corporation at the prevailing market interest rate of 6% while the equity capital employed of 1,000 units in each case yields a return of 15%. Total earnings (and the present value of total tax payments) are then independent of legal form.

221. Beyond the assumptions used in these examples, however, differences in tax burden unavoidably persist due to the progressive rate of income tax. The main beneficiary in the case of corporations, however, is the component of the additional earnings which is not paid out as a reasonable manager salary but is subject to income tax as capital yield of the shareholders. On the other hand, situations may arise when a partnership is better off under tax than a corporation. That would be the case, for example, if a company had a bad performance and its profits made up only (or not even) the standard entrepreneurial reward. Transparent entities would be favoured here (up to the standard return on equity capital); with corporations, on the other hand, this would depend on whether the entrepreneurial reward is displayed and paid out as salary for it would then be subject to income tax at the normal progressive rate in any case.

3.3.3 Determination of the Return Component

3.3.3.1 Scope of Business Assets to Be Included

3.3.3.1.1 Compulsory and Optional Business Assets

222. If we assume that an average return on capital invested is to be subject to a proportional capital tax rate, the first step to take would be to determine the actual size of the capital on which that return has to be earned. The best course for determining the return component would seem to take the business assets as a starting point and, hence, the valuation approaches used in assessing profits for tax purposes. Accounting, therefore, proves to be essential for splitting profits along dual income tax lines. This has already been made clear in terms of the scope of businesses entitled to favourable treatment (section 205 pp.).

223. So if we take business assets as a starting point for preferential tax treatment, the first thing we have to consider is how to properly adjust the borderline to be drawn between business and private spheres. If we are not to rewrite the law on tax accounting, it is advisable to depart from the list of assets covered by § 4 para. 1 ITA. In the first instance, assets to be included in the calculation base are those which, in accordance with the common definition of compulsory business assets

“serve the business so directly that they are objectively recognisable as being determined to be employed unambiguously for business purposes”.⁹⁰

224. On the other hand, it may appear doubtful whether the group of assets called ‘optional business assets’ should also be included when calculating equity capital. On this basis, assets which an entrepreneur dedicates to his business may be recognised as business assets, provided they have a certain objective connection with the business and objectively suit its demands.⁹¹ There are good reasons against accepting this wide definition of business assets established by case law for the purpose of calculating the return on equity capital. Ultimately, this crucially depends on whether it is possible to separate those assets in practice which are held within business for *potentially* income-yielding purposes from those which are ultimately *de facto* assets used for consumption purposes only and which, thus, do not meet the requirements indispensable for a preferential rate of return on tax. However, also ‘optional business assets’ may be included when calculating the equity capital on which a return is to be earned, as long as we set high standards for the act of allocating assets to the business and strictly exclude those only consumed.

3.3.3.1.2 Cash

225. The purpose of the return base is to represent the class of income yielding assets. It is, therefore, doubtful whether cash should be included in the calculation base. By way of excluding it, we can also counteract attempts of ‘creative accounting’ which shift liquidity to the business only temporally in order to increase the imputed return component of its total profits. The only other way of countering such ‘creative accounting’ would be imposing a duty to day-to-day assessment, which involves a great deal of administrative work: The argument on balance is that cash should be excluded from equity as a return base.

3.3.3.1.3 Trade Receivables

226. Notwithstanding trade receivables do not yield any profits, they are nonetheless part of the business working capital in a broader sense. Furthermore, there will be little room for creative tax accounting in any case: Thus, this item should, therefore, be included in preferentially treated working capital.

3.3.3.1.4 Financial Capital

227. Income from financial capital, where held as private assets, is classified as capital income without differentiation. Nor is it split into a return component subject to capital tax and an earnings component to be progressively taxed. If capital income is to be treated consistently, nothing must change in terms of how the return on capital actually obtained is recorded if financial capital is held as part of

⁹⁰ See, for example, BFH, July 23, 1975 - I R 6/73, BStBl II 1976, 179.

⁹¹ See, for example, BFH, February 19, 1997 - XI R 1/96, BStBl II 1997, 399.

business assets. Otherwise, there could be room to maneuver on the borderline between business and private assets if the returns actually yielded on the capital market were greater or lesser than the standard rate of return the law proposes.

3.3.3.1.5 Holdings in Corporations

228. Special treatment is required for the case that a partnership or a sole proprietor holds shares in a corporation because any earnings such corporations made are subject to the provisions of the dual income tax model primarily designed for them. Corporate profits are, first, taxed proportionally and later again when distributed to the shareholders to the amount that exceeds the standard rate of return on the acquisition costs of the shares.

229. The relief method that finds application on this second level depends on the way the shareholder is legally organised. Dividends received by corporations are entirely, those received by individuals or partnerships partially tax-exempt, in the latter case depending on how the share values are compounded. Under the current half income method, for the reasons given above, a kind of auxiliary calculation is provided attributing the income concerned to the shareholders on a pro rata basis and, thereby, ensuring appropriate taxation according to the legal form of the shareholder (§ 8b para. 6 CTA for corporations as co-entrepreneurs). The differentiated compounding method means that profits can be consistently and separately assessed only by using the so-called procedural net method, which makes inserting § 7 clause 4 TTA necessary in any case.

3.3.3.1.6 Holdings in Transparent Entities

230. The German Federal Tax Court still adheres to its proposition that a holding in a partnership can not be capitalised for accounting purposes. Profits and losses are directly attributed to the partners under income tax law. Calculating the individual preferentially taxed profit component is applied to suit transparent taxation. Assessing profits uniformly and separately at company level shows shareholders how much they actually own of the company's total capital and, hence, their return component as input variable.

231. If a partnership is engaged in another partnership, we must add the return component attributed to the latter to the return component calculated based on the former partnership's assets. This ensures the capital, and the return on it is given a preferential treatment in line with the system at the level of the shareholder behind it.

3.3.3.1.7 Intangible Assets

232. Acquired intangible assets, including acquired goodwill in the event of an asset deal, are part of the company's accounts (or at least of the partners' supplementary accounts). These assets are, therefore, automatically included when calculating the equity capital on which the return is to be imputed. Regarding self-

created intangibles it should be noted that for R&D expenditures immediate deduction is allowed: This may reduce the 'return base' on the one hand, but on the other hand the taxpayer obtains a countervailing tax benefit from the fact that investing in self-created intellectual property is totally tax-exempt for the present. Benefits would be multiplied, quite contrary to what the system intends if we allow such costs to be deducted on the one hand and include them in the basis for the preferentially treated return on capital on the other hand.

3.3.3.1.8 Business Assets Situated Abroad

233. For the case that national law or a double taxation treaty provide that income derived from business assets situated abroad, particularly from immovable property or business assets attributed to a foreign permanent establishment, shall be taxable in the other state, the question may arise if and to what extent these assets should be included in the equity base to calculate the return component.

234. For German tax claims, under the law as it stands in Germany, there are three ways to take account of foreign tax liabilities:

- The income tax paid in the other state can be deducted from German income tax under a double taxation treaty or § 34c para. 1 ITA (option a).
- If no double taxation treaty exists, the taxpayer can opt to have the foreign tax deducted from his tax base (§ 34c para. 2 ITA) (option b).
- The foreign income is exempted from tax under a double taxation treaty (option c).

235. No modifications are required in the case of option a. The foreign income is included when calculating profits. The preferentially taxed return component is identified including the assets situated abroad. If the tax paid abroad exceeds domestic tax liability due to the proportional rate applied in Germany, this may leave an 'over-spill' which may not be offset.

236. In the case of option b, consideration could be given as to whether the return component calculated including the business assets abroad could be reduced by the deduction allowed for the tax paid abroad. This would concentrate the relief entirely on domestic income in Germany. However, as this would be seriously to the detriment of investments abroad, any restriction of this kind would be highly unlikely to be compatible with the basic freedoms under the EC Treaty.

237. The most important question is whether, in the case of option c, the return component itself should be reduced by the income exempted or rather the return base by the assets situated abroad. Reducing the return component by the income exempted runs the risk of over-compensating for the case that the foreign income exempted exceeds the return component based on the working capital situated abroad: This is the case because tax-exempt foreign income would be indirectly set off to the detriment of the domestic return, so that income generated in Ger-

many would be subjected to tax at the normal rate even if it were within the scope of the standard return on the working capital situated in Germany.

238. It would, therefore, be advisable to eliminate business assets situated abroad from the return base used in calculating the preferentially treated return component from the outset.⁹² Profits taxable in Germany would, therefore, only be taken into account as they represented a return on the working capital situated in Germany. This would have adverse consequences in law for outbound investment compared with investment purely within Germany if the profits actually obtained abroad fell short of the return on capital on the assets abroad as the return on the assets abroad would at least partially be ‘lost’. It would, therefore, be worth considering whether this would not amount to an unlawful restriction of the freedom of establishment and free movement of capital enshrined in Community law (Art. 43 and 56 of the EC Treaty). The constellation in question is similar in this respect to excluding losses incurred by a foreign permanent establishment from being offset against positive income in Germany or refusing to allow some or all stewardship costs to be deducted from tax-exempt dividend income.

239. This approach might be justified on the grounds of ‘coherence’ of the national tax system, however. According to European Court of Justice case law, rules which restrict cross-border investments may be justified by tax benefits, provided the advantageous and disadvantageous rules as a whole ensure a coherent taxation system.⁹³ The tax advantage which shall be achieved with calculating a return component is characterised by an immediate connection between business income and the investment underlying that income. If income generated abroad is tax-exempt, the assets from which that income derives consequentially cannot be included when calculating the standard rate of return in Germany. The European Court of Justice followed similar considerations in a more recent decision on setting off losses abroad within a group when it recognised in principle that the scope of a Member State’s tax law is by nature limited to economic activities established within its borders to ensure that the allocation of power to impose taxes between Member States is well-balanced.⁹⁴ Excluding business assets situated abroad from the return base is, therefore, compatible with the requirements of Community law.

3.3.3.2 Assessing the Value of Assets

240. The business assets used in the return base are, as a general rule, valued in accordance with tax accounting principles, therefore, hidden reserves, especially in the field of real property, are not included in the calculations. This approach is justified both in normative and economic terms. Creating hidden re-

⁹² See, for example, Art. 205^{ter} §§ 2, 3 of the Belgian CIR as enacted by loi du 22 juin 2005.

⁹³ See case C-204/90 *Bachmann* [1992] ECR I-249, para. 21 to 23; Case C-300/90 *Commission v Belgium*, Coll. [1992] ECR I-305, para. 14 to 16.

⁹⁴ See case C-446/03 *Marks & Spencer* [2005] ECR I-10837, para. 45 pp.

serves is subject to the realisation principle whereby no tax is incurred until the accrual of reserves concerned is actually realised. If the State's claim to share in the profits is, thus, deferred, the taxpayer foregoes her claim for preferential income treatment.⁹⁵ The tax-book value approach also counteracts attempts to use disproportionate depreciation or make provisions in order to reduce an enterprise's capital costs.

241. This approach needs to be extended to the valuation of depreciable fixed assets employed for yields from rent and lease. Any hidden reserves would only be included when calculating the return base if the accretion of assets was not already subject to capital gains tax under the existing § 23 para. 1 clause 1 no. 1 ITA.

3.3.3.3 Mid-Year Changes

242. How should we respond to the fact that business assets are subject to changes in value and inventory over the financial year? In principle, changes in inventory are allowed for by referring to the average of the opening and closing balances for the assessment period in question. Selecting a single cut-off date to establish the return base could prove problematic as taxpayers may try to manipulate this 'snapshot' value by adding or removing inventory just before or after it. Therefore, one might consider a certain range of inventory and value figures (for each quarter, for example) and averaging them. For fairness reasons, as proposed here, it may also be acceptable to give the taxpayers the opportunity to use even more short-term snapshots (e.g., quarterly) to report a higher value.⁹⁶

3.4 Deduction of Liabilities (and Debt Interest)

3.4.1 The 'Gross Method' vs. the 'Net Method'

243. Once we have agreed upon the scope of (narrowly or widely defined) business assets to be included in the return base, the next step to be taken involves deciding how we are to treat liabilities and the capital charges on them. In this respect the question of how to qualify interest on debt for tax purposes will turn out to be the crucial point. There are two options here:

- Either the amount of liabilities is deducted from the total of assets before splitting up between a return and earnings component or interest payments reduce

⁹⁵ Correspondingly, Belgium excludes increases in value which are shown but not realised under Art. 205^{ter}, § 5 CIR from the assessment base for the *déduction fiscale pour capital à risque*.

⁹⁶ This is the practice in Norway (Skattedirektoratet, 2005: 797).

the profit (*net method*). Proceeding this way the preferentially treated part of the business profits is calculated by imputing a return on the net assets.

- Alternatively, we could decide not to deduct liabilities from the total of assets or interest payments from total profits. While this approach opts for a higher return base as the starting point, i.e. gross assets, interest, however, can only be deducted from the standard return on gross capital but not from the earnings component taxed at the normal rate from the outset (*gross method*).

244. For the decision between the two methods, the fact has to be pointed out that debt interest which businesses are allowed to deduct are typically subject to preferential capital taxation as far as the lender is concerned, no matter whether the profits the debtor earns are high or low, whether her profits exceed the standard return on capital or whether she even incurs a loss. This preferential tax treatment is something the creditor enjoys even if the actual capital market interest rate, which is constantly changing and depends on who the debtor is, differs from the standard rate of return fixed by the law. Using the ‘net method’ might mean that taxpayers would stand to benefit from taking on more debt if the interest rate they pay exceeds the statutory return on the capital they employ.

245. Profit-splitting must be based on gross profits before interest in order to counteract any attempts of tax arbitrage. Gross profits are then to be split into a standard rate of return on business assets less debt interest (return component) and the fraction of profits that is taxed at the normal rate (earnings component). As a consequence low-taxed interest can only ever be deducted from low-taxed capital income. If we applied the net method instead, interest payments would reduce the total of business income so that the tax base is identified by the company’s profits after interest, leaving the risk that interest that is taxed at a low proportional rate on the recipient’s part would, on the other side, de facto reduce that fraction of profits that is taxed at the normal progressive rate on the borrower’s part a bias that is to be avoided.

3.4.2 Gross Method

3.4.2.1 How It Works

246. One good way of explaining how the gross method works is to use eq. (1), which analyses the total tax burden on operating profits by the two components. It will be evident that, by applying the gross method, debt interest does have an effect only within the framework of the preferentially taxed return component but leaves the earnings component of operating profits, which is subject to tax at the normal rate, completely untouched:

$$T = \underbrace{(A * k - B * i) * t_C}_{\text{return component}} + \underbrace{(Y - A * k) * t_I}_{\text{earnings component}}; \quad (1)$$

with

T	=	total tax liability
A	=	assets
B	=	net balance of liabilities and financial assets
Y	=	profits before interest
i	=	nominal rate of interest
k	=	standard rate of return
t_I	=	income tax rate
t_C	=	capital income tax rate.

At the same time, by converting the second total in this equation, i.e. the earnings component, it can be easily shown that calculating the earnings component by taking the profits and deducting the compounded business assets is equivalent to deducting the return component from net profits after interest as shown in the annual tax balance sheet:

$$Y - (A * k) = (Y - B * i) - (A * k - B * i). \quad (2)$$

There is, therefore, no need to separately calculate gross profits when using the gross method in practice. Instead the profit-splitting can depart from net profits in any case.

3.4.2.2 Calculating the Return Component

247. The return on assets calculated as shown in the previous sections is reduced by the debt interest actually paid to give the preferentially treated return amount. Where financial assets used for the purpose of equally treating capital income inside and outside businesses are not included in the return base, the resulting capital yields must be attributed to the return component.

248. Overall, this gives the diagram for calculating the total amount of the preferentially treated return component as shown below (Table 22).

249. Deducting debt interest at its actual amount may give the return component a minus value, even though the equity capital itself is positive. If, in the present case, the earnings component to be progressively taxed was formed from the difference between the net profit and return component as in eq. (2), debt interest in excess of the return on capital would be taxed on a progressive basis.

250. Irrespective of the question as to whether such an extensive method of gross taxation is compatible with the principle to tax net income conventionally derived from the principle of taxation according to ability-to-pay, this imposes a

serious restriction on the financial framework conditions for debt-financed businesses and for start-ups and small and medium-sized companies in particular.

Table 22. Dual income tax: Calculating the return component of transparent entities

	Assets as per tax accounts
-	Cash
-	Financial assets
-	Securities
-	Shares in corporations of all kinds
=	Return base
*	Standard rate of return
=	Gross return on capital
+	Capital yields
-	Interest on debt
=	Return component

251. There are a number of options available to solve this problem:

- One rather rough approach would be to disregard any non-positive return component. However, this would mean that one of the essential characteristics of the gross method, namely that it allocates debt interest consistently to the proportionally taxed component of income, would get lost. This is unacceptable for reasons of neutrality.
- It would appear preferential, on the other hand, to have an arrangement whereby only the annual profit actually earned net of interest is subject to tax. To prevent any advantage being drawn from high leverage, a negative return component must be carried forward and reduce the return base of subsequent years accordingly, however. This means that we must adopt an approach already applied for reasons of setting off of losses in an intertemporal context, which ensures that viewed from a life-time perspective the company's interest payments are consistently offset against the standard return on its assets.

Example 23: How to carry forward a non-negative return component is illustrated by means of a simplified calculation (Table 23). A business yields a gross annual return on capital before deducting interest of 100 units (ignoring interest effects for the sake of simplicity). In Years 1 and 2, debt interest exceeds the gross return on capital giving a negative return component. Ineffective return components, which are negative in this case, must be carried forward reducing subsequent positive return components accordingly. In this example, carrying forward the negative return component of 100 units reduces the return component in Year 3, which is 100 units as there is no debt interest to pay this year. The negative return components can be recorded via the same account as the one used to carry over positive return components which have not been effective. The total gross return on capital over the three years is 300 units: As debt

interest is equal to this, this gives a cumulative return component of zero (excluding interest effects in each case): The total net profit of 300 is taxable as non-preferentially treated profits.

Table 23. Setting off non-positive return components under the gross method

	Year 1	Year 2	Year 3	Total years 1 - 3
(1) Profit before interest (Y)	200	200	200	600
(2) Debt interest ($B * i$)	150	150	0	300
(3) Profit after interest [(1) - (2)]	50	50	200	300
(4) Gross return on capital ($A * k$)	100	100	100	300
(5) Return component carried carried [(9) / ($t-1$)]	.	- 50	- 100	.
(6) Applicable return component [(4) - (2) + (5)]	- 50	- 100	0	- 150
(7) Return component to be applied {max [0; (6)]}	0	0	0	0
(8) Earnings component [(3) - (7)]	50	50	200	300
(9) Return component to be carried forward [(6) - (7)]	- 50	- 100	0	.

252. Return components can be carried forward in the same way when losses and negative return components occur at the same time. The general rules apply. Losses must be absorbed first; any losses not absorbed must be carried forward. Any non-used return components must be carried forward, negative carry-forwards reducing subsequent positive returns to give the return on equity capital.

Example 24: A business incurs a loss at first (Table 24). It earns a gross annual return on capital before deducting interest of 100 units, as before: Once again interest effects are ignored. The losses incurred in Years 1 and 2 are carried forward as are the negative return components. In Year 3, the profits made are applied to absorb the losses in the first instance. The negative return component carried forward reduces the periodic return component calculated for Year 3 resetting the usable return component to zero. The profits remaining after absorbing the losses must, therefore, be taxed as non-preferentially treated income. The outcome is that interest payments do reduce the annual profits not preferentially treated without any limitations but at the same time take away the opportunity of shielding subsequent profits from the higher tax burden of income tax.

253. Carrying forward return components, both positive and negative, may be ineffective if a business ceases to make any profits which would be subject to tax in future. Procedures must, therefore, be put in place as how return components are to be dealt with if they are left over once a business closes or is disposed of. The first option, in principle, would be to transfer any return components not used to other business assets. If such transfers were allowed, they would also have to be possible before a business was closed or disposed of if the taxpayer runs more than just one business (such as a sole proprietorship and a share in a partnership, for example). The second option would be to tie the return on equity capital to the business it was calculated for: This would be simpler in administrative terms than transferring it to another business and ensures taxation neutrality as to legal form

insofar as the return allowance would also be tied to the underlying shares in the case of holdings in corporations (section 137 pp.). This second approach is, therefore, proposed but it should be kept in mind that the sum of accrued return components would get lost once the business is shut down.

Table 24. Setting off losses and negative return components under the gross method

	Year 1	Year 2	Year 3	Total of years 1 - 3
(1) Profit before tax (Y)	0	100	300	400
(2) Debt interest ($B * i$)	150	150	0	300
(3) Profit after interest [(1) - (2)]	- 150	- 50	300	100
(4) Gross return on capital ($A * k$)	100	100	100	300
(5) Return component carried forward [(10) / ($t-1$)]	.	- 50	- 100	.
(6) Applicable return component [(4) - (2) + (5)]	- 50	- 100	0	- 150
(7) Loss carried forward [(11) / ($t-1$)]	.	- 150	- 200	.
(8) Return component to be applied {max[0; (6)]}	0	0	0	0
(9) Earnings component {max[0; (3) + (7) - (8)]}	0	0	100	100
(10) Return component to be carried forward {min[0; (6)]}	- 50	- 100	.	.
(11) Loss to be carried forward {min[0; (3) + (7)]}	- 150	- 200	.	.

3.4.3 Net Method

254. Under the net method splitting profits and determining their return component takes net equity as displayed in the tax accounts as the starting point of calculation. Progressively taxed earnings income is then obtained by deducting the return component, thus, calculated from the net profits. In contrast to the gross method, the earnings component now depends on the relationship between the capital market interest rate and the standard rate of return.

255. A company's total tax burden using the net method is obtained using the formula:

$$T = \underbrace{(A-B)*k}_{\text{return component}} * t_C + \underbrace{[Y - B*i - (A-B)*k]}_{\text{earnings component}} * t_I \quad (3)$$

The calculation is, therefore, based on the company's equity capital as measured at the end of the previous year, in the case of partnerships also including the capital as shown in any supplementary accounts or at the second stage of assessment the capital shown in the special accounts.

256. For the same reasons as with the gross method, assets that generate tax-exempt income, i.e. mainly business assets abroad, must be excluded from the cal-

ulation base. On the other hand, excluding trade receivables and financial assets would not be in line with the system.

3.4.4 Leeway for Creative Accounting

3.4.4.1 Increasing the Capital Accounts

257. If the return base is based on the company's equity or on a partner's equity account, as with the net method, this may create an incentive to level or step them up by making short-term deposits. Such creative accounting was also to be found in connection with previous rules which provided relief for retained profits in Germany (such as § 32b ITA in 1951-1953 or § 10a ITA up until 1992). The Brühl recommendations banned any form of setoff for this purpose, thereby, restricting the variability of equity accounts accepted by commercial law for tax purposes only. Such a procedure makes it possible to identify the actual amount of capital withdrawn; however, the resulting model games made it clear how much administration work would be involved and how unpopular the idea of prohibiting such setoff was.

258. More appropriate, perhaps, would be a netting provision as in § 4 para. 4a ITA enacted in 1999.⁹⁷ According to clause 3 of that provision deposits and withdrawals made in the first and last quarter of the fiscal year would be offset; but this provision was abolished very soon under the Tax Amendment Act 2001⁹⁸, as it delayed tax assessment in time and, furthermore, would not have prevented abusive creative accounting anyway.⁹⁹ To meet the requirements of practicability on the one hand while counteracting possible creative accounting on the other hand, what is needed are procedures which provide for the return base to be based on the average balance on individual accounts calculated on a quarterly basis. With the gross method, the problem of short-time injecting liquidity into a business cannot arise in the first place provided cash is not included in the calculation base for calculating the return component (section 225).

3.4.4.2 Re-Characterisation of Private Debts

259. Even under income tax law as it stands, considerable legislation has proven to be necessary on the question of whether, and, if so, how companies acquiring loan capital can or should be examined as to whether these funds 'actually' serve private consumption and, hence, cannot be deductible expenses for tax purposes in accordance with the net principle of determining taxable income. This, of course, is also a 'hot topic' in the regulation model as proposed here. By apply-

⁹⁷ See December 22, 1999, BGBl. I 1999, 2601.

⁹⁸ See December 20, 2001, BGBl. I 2001, 3794.

⁹⁹ See Memorandum to the government's bill, Bundestag printed paper 14/6877, 24.

ing the gross method, dual income tax reduces the incentive to transfer private debt into the business sphere as interest payments reduce the size of the return component and, thus, count against the preferentially taxed fraction of profit.

260. At the same time, it should be pointed out that the problem of re-assigning private debt is primarily a practical one. It starts by assuming that, when credit is raised, whether it is for ‘business reasons’ can be determined by the purpose for which the funds taken up are to be used. In the case of cash, however, – as the apparent contradiction between ‘withdrawal-based loans’ and ‘loan-financed withdrawals’ shows – this is a matter open to considerable creativity and very hard to verify. Having this in mind, the Federal Tax Court has declared taxpayers largely to be free to decide how they wish to structure their affairs (multiple-account models).¹⁰⁰

261. According to the pragmatic solution enacted by the German legislator in 1999¹⁰¹ no further allowance was given for deducting any expenses in the case of negative equity accounts. Unlike the predecessor rules introduced by the Tax Relief Act 1999/2000/2001¹⁰², the new version of § 4 para. 4a ITA has not yet met any overriding practical or systematic objections.

3.4.4.3 Shifting Private Financial Assets

262. What appears more important under dual income taxation is when taxpayers try to exploit the de facto difference between the standard rate of return and current capital market interest rates to obtain tax advantages. This is done mainly by acquiring or shifting (low-return) private financial assets to the business sphere or by acquiring or shifting (high-return) loans to the private sphere.

263. The gross method proves to be superior to the net method here. If a uniform net operating capital is calculated using the net method, it ‘automatically’ follows that financial assets raise a preferentially treated imputed return on capital if the yields actually realised fall short. Conversely, a high interest rate loan could generate a high interest burden reducing companies’ profits (and, hence, the progressively taxed earnings component of that company’s profits). This is more difficult to arrange with the gross method, which excludes financial assets at the outset; high debt interest rates result in an adverse setoff with future positive capital returns.

3.4.4.4 Debt Financing of Operating Expenses

264. Even under dual income tax, the general rule remains in force that debt interests are recognised as business expenditures that are deductible if incurred in

¹⁰⁰ See BFH 8.12.1997 - GrS 1-2/95, BStBl II 1998, 193.

¹⁰¹ See amendment of December 22 1999, BGBl. I 1999, 2601.

¹⁰² See March 24 1999, BGBl. I 1999, 402.

the course of a business aiming at deriving profits. On the other hand, the ‘tracing principle’ applying for business expenses makes no distinction as to whether the funds are used to invest in assets or to finance current business expenditure.

265. The result can be that, from the creditor’s viewpoint, the payments received for supplying debt are considered as (preferentially treated) capital income while the debtor can deduct them from his business income. This is obvious when applying the net method; but it also applies under the gross method if (as is proposed here) any ‘negative return component’ is not actually taxed, merely carried forward to subsequent years: Since, if an entrepreneur uses loans to finance his business’s current expenditure (paying wages, for example), the resulting debt interest reduces their profits, which are taxed at the standard rate, whereas the person receiving the interest is only liable to tax at the preferential capital tax rate.

266. This may open opportunities for ‘creative accounting’ especially in cases of debt if creditor and debtor are connected in a close economic or personal relationship, which means they have a shared interest in the tax-induced net outcome of the transaction. In this case, any differences between the actual rate of return on the capital employed and the statutory rate of return reduces the tax liability on the debtor’s part via the progressively taxed earnings component, which the creditor does not have to make up for as the tax on capital is uniformly proportional. One might particularly think here of debt financing by close relatives of the taxpayer.

267. This problem has already been seen in other countries. In Norway, this has resulted in the law laying down that debt interest is only deductible on loans by non-related third parties,¹⁰³ thus, interest debt on loans by close relatives is not deductible. Such a hard solution is not to be recommended in view of German constitutional law and its prohibition on discriminating against marital or family relationships. But there is still one way of avoiding such creative accounting: the possibility of correcting income using an arm’s-length standard although this does not prevent profits from being transferred up to a reasonable rate of return.

268. Otherwise, the limits to ‘creative accounting’ remain as above: In the event of a ‘negative return on capital’, exceeding negative interest amounts are ‘carried forward’, and debt interest is excluded if withdrawals exceed profits and deposits in the year in question.

3.4.4.5 Conclusions

269. In conclusion, we can say that the gross method proves to be much more resistant to ‘creative accounting’ in many respects and is much better at ensuring that private and business capital gains are equally treated than the net method. It is, therefore, preferable as a whole as a method for calculating the profit component to be taxed preferentially, as the following example conclusively shows.

¹⁰³ See tax law § 12-12 para. 2 a.

Example 25: Consider a transparent entity with assets of 1,000 units, 700 units of debt and an equity capital of 300. Let its overall return on capital be 15% and the standard rate of return 6%. The debt interest rate is also set at 6% or in an alternative calculation at 8%. Preferentially taxed profits are taxed at 25%, any profits above that at the top rate of income tax of 44.31% (including solidarity surcharge).

Table 25. Dual income tax: Calculating profits by the net and gross method for transparent entities

	Interest rate	
	6%	8%
(1) Assets	1,000	1,000
(a) Debt	700	700
(b) Equity capital	300	300
(2) Profit before tax $[0.15 * (1)]$	150	150
(3) Debt Interest [interest rate * (1a)]	42	56
(4) Profit after interest [(2) - (3)]	108	94
Net method		
(5-N) Return on equity capital $[0.06 * \{(1) - (1a)\}]$	18	18
(6-N) Profit after interest in excess of return on equity capital [(4) - (5-N)]	90	76
(7-N) Income tax $\{[(7a-N) + (7b-N)]\}$	44.38	38.18
Of which:		
(a) On return on equity capital $[0.25 * (5-N)]$	4.50	4.50
(a) On profits after interest in excess of return on equity capital $[0.4431 * (6-N)]$	39.88	33.68
(8-N) Profit after tax [(4) - (7-N)]	63.62	55.82
(9-N) Tax on interest income $[0.25 * (3)]$	10.50	14
(10-N) Interest income after tax [(3) - (9-N)]	31.50	42
(11-N) Total tax burden $\{[(7-N) + (9-N)]\}$	54.88	52.18
(12-N) Total income after tax $\{[(8-N) + (10-N)]\}$	95.12	97.82
Gross method		
(5-B) Return component $\{[0.06 * (1)] - (3)\}$	18	4
(6-B) Earnings component $[(2) - 0.06 * (1)]$	90	90
(7-B) Income tax $\{[(7a-B) + (7b-B)]\}$	44.38	40.88
Of which:		
(a) On return component $[0.25 * (5-B)]$	4.50	1
(b) On earnings component $[0.4431 * (6-B)]$	39.88	39.88
(8-B) Profit after income tax [(4) - (7-B)]	63.62	53.12
(9-B) Tax on interest income $[0.25 * (3)]$	10.50	14
(10-B) Interest income after tax [(3) - (9-B)]	31.50	42
(11-B) Total tax burden $\{[(7-B) + (9-B)]\}$	54.88	54.88
(12-B) Total income after tax $\{[(8-B) + (10-B)]\}$	95.12	95.12

Table 25 shows clearly the advantages of the gross method and disadvantages of the net method. With the net method, the total tax burden depends on how high debt interest is compared to the imputed rate of return. As interest expenses reduce the earnings component, agreeing on debt interest exceeding the standard rate of return – such as with loans between closely related persons – leads to tax savings: While the recipient pays tax on the considerably higher interest at a rate of 25%, this burden is outweighed by the tax savings obtained by the company if the profit component in excess of the return on equity capital is subject to the top rate of in-

come tax. As a general rule, this means that there are fewer incentives when using the gross method, precisely for persons close to one another in contractual relations.

3.5 Interest Rates

270. Determining the interest rate to be used in calculating the preferentially treated return component is based on the same considerations, in principle, as for compounding shareholders' share value of an entity liable to corporation tax. The starting point is, therefore, the function of the standard rate of return in ensuring finance neutrality in respect of marginal investment. Since, where profits are lower than the standard rate of return on the capital employed, this difference indicates a step-up of next years' return basis (as in the case of loss offsetting), any further risk surcharge is unjustified. The State thus assumes a symmetrical part of the investment risk, just like a shareholder.¹⁰⁴ In any case, a risk surcharge would also discriminate against zero-risk investments outside the enterprise and, thereby, put capital at risk of not being efficiently allocated.

271. For the same reason, we must also reject a justification that a risk surcharge would be likely to avoid a negative return component arising, which may be the case if interest costs are high, especially when a company has only just been incorporated and it incurs initial losses. A higher rate of return could be used in this case to avoid taxing an 'unreal profit'. At the same time, such an approach runs contrary to the basic principle underlying the gross method of only including debt interest under capital income. It is in line with this strict approach to equalise a 'negative return' between periods and to show the earnings component, on the other hand, as a constant of the difference between gross profits and gross return.

272. In addition to that the argument would not be convincing that the lower capital approach guided by the book values of business assets, which arises from excluding unrealised hidden reserves and self-created intangible assets, would have to be made up for by a higher rate of return to reflect the enterprise's real earnings position. That the book value approach was selected in line with tax accounting has already been shown in connection with developing the return base and justified as making up for deferring tax under the realisation principle.

273. Finally, a higher rate of return in comparison to corporations could be based on the reduced availability of timing benefits. In fact, the separation principle generates liquidity benefits for corporations as any excess profits not distributed as dividends can be reinvested at a low rate of tax. On the other hand, it should be noted that with partnerships the return on capital also shares in the low

¹⁰⁴ See ot.prp.nr.1 (2004-2005): Skatte – og avgiftsopplegget 2005 – amendments to the law, 38.

progressive zone up to a marginal tax burden of 25% inasmuch this is not used by other sources of income (section 277 pp.).

3.6 Taxing Extraordinary Transactions

274. For our present purposes, the extraordinary transaction we will consider here is sale of a business. Reorganisation tax law matters are discussed in section 283 pp.

When selling a business, the taxpayer calculates the taxable capital gains from the difference between the selling price and the book value of the business assets or the capital account attributable to the partner (less disposal costs incurred). In contrast to disposing of a share in a corporation, there is no reason to record the partnership's open reserves as these are already subject to tax under transparent taxation.

275. We may, therefore, assume that the capital gains to be taxed consist only of untaxed hidden reserves, inherent goodwill, if any, and a proportion of business profits. These profits must be preferentially taxed, insofar as applicable return amounts can be 'carried forward' from preceding years and insofar as an additional return on capital can be included in the current year.

Example 26: X disposes of his partner's share as of June 30 in Year 1 for the price of 600 units. His capital account at this time is 400 units. The return on equity capital base is also 400 units; the return brought forward is 100 units. The pro rata return component of the profits in Year 1 is

$$\frac{6}{12} * 0.06 * (400 + 100) = 15 .$$

Of the capital gains amounting to 200 units, 115 units are, therefore, preferentially taxed as return component. If the selling price were only 500 units, contrary to the assumptions in Example 27, all of the capital gains, i.e. 100 units, would count as the preferentially taxed return component. The non-applied return component of 15 units (115 - 100) is lost (section 253).

276. The preferential taxation under § 34 ITA is justified by the distortions a progressive tax rate causes on cumulative profits compared to a multiple period approach. With this aim in mind, the components of profits must be removed from the scope of this rule which would be subject to low tax as return components. It would then be consistent to remove earnings income that is subject to a lower marginal tax burden than the rate of capital tax from the scope of this rule.

3.7 The Tax Rates

277. In line with the idea of a dual income tax, the profit component which corresponds to the return component must be proportionally taxed in principle while any profits beyond those must be taxed progressively as earnings income.

278. A flat tax rate of $25\%/(1 + \text{solidarity surcharge})$ for this part of profits that is defined as capital income means that the position might be worse than under the law as it stands, which provides for the whole taxable income to be taxed at a starting rate of 15% (without solidarity surcharge). Considering that the overwhelming majority of German businesses are small and medium-sized companies, the tax level should be retained up to a marginal tax rate of $25\%/(1 + \text{solidarity surcharge})$.

279. There are two potential solutions here:

- *Schedular model:* On the one hand, based on a comparison of total tax burden, the return component could be assigned to a band of income subject to a progressive tax function if this would be more favourable to the taxpayer since the basic allowance and progressive tax schedule mean that, at a starting tax rate of 15%, taxing profits at 25% could be detrimental compared with taxing at the income tax rate. A tax detriment appears if the tax payment is firstly calculated by applying the income tax rate, and that tax payment is compared with the payment which results if capital income is deducted from income as a whole, tax on the remaining (earnings) income is calculated at the current rate and that tax is then increased by 25% of capital income. The governing variable for comparing taxes here is the average tax burden but this depends on the individual relation between return and earnings components. Only if the total profit is equal to the return on capital does equality of taxation prevail at an average tax burden of $25\%/(1 + \text{solidarity surcharge})$, that is based on the tariff for the assessment period 2005, at a profit of EUR 41,900.
- *Extended tariff:* The total of income is subjected to a uniform tax rate function. With a marginal tax burden of $25\%/(1 + \text{solidarity surcharge})$ or above, a proportional band is provided, the length of which depends on the amount of capital income to be taxed.¹⁰⁵ The tariff formula in § 32a ITA has, therefore, been modified as follows (Table 26).

¹⁰⁵ Under § 3 of the solidarity surcharge law 1995, the solidarity surcharge is only levied on a person liable to pay income tax if the assessment base exceeds the sum of EUR 972/EUR 1944. This rule has been ignored in the following for the sake of simplicity.

Table 26. Income tax under dual income tax

Total taxable income	Income tax rate
1. Up to € 7,664 (basic allowance):	0
2. From € 7,665 to € 12,584:	$(883.74 * x + 1,500) * x$
3. From € 12,585 to € 12,585 + K:	$(x - 12,584) * 0.25 / (1+t) + 952$
4. From € 12,586 + K to € 12,739 + K:	$(883.74 * y + 1,500) * y + K * 0.25 / (1+t)$
5. From € 12,740 + K to € 52,151 + K:	$(228.74 * z + 2,397) * z + 989 + K * 0.25 / (1+t)$
6. € 52,152 and over:	$0.42 * (v - K) - 7,914 + K * 0.25 / (1+t)$

Explanation:

K is capital income, rounded off to the nearest euro
x is one ten-thousandth of the total taxable income component in excess of € 7,664, rounded off to the nearest euro
y is one ten-thousandth of the total of € 7,664 and the component in excess of the capital component of the total taxable income rounded off to the nearest euro
z is one ten-thousandth of the total of € 12,730 and the component in excess of the capital component, rounded off to the nearest euro
v is the total taxable income, rounded off to the nearest euro
t is the surcharge rate applicable under sec. 4 of the solidarity surcharge law 1995 (currently 5.5%).

Table 27. Comparing tax liabilities and average tax rates: Income tax schedule 2005 vs. dual income tax – Profit = Return component

Taxable income			Income tax liability			Average tax rate		
Profits	Of which:		Tax rates 2005	Dual income tax		Tax rates 2005	Dual income tax	
	Return component	Earnings component		Schedular model	Extended tax schedule		Schedular model	Extended tax schedule
Euro						%		
0	0	0	0	0	0	0	0	0
1,400	1,400	0	0	0	0	0	0	0
3,500	3,500	0	0	0	0	0	0	0
7,664	7,664	0	0	0	0	0	0	0
7,700	7,700	0	5	5	5	0.06	0.06	0.06
9,800	9,800	0	360	360	360	3.67	3.67	3.67
11,900	11,900	0	793	793	793	6.66	6.66	6.66
14,000	14,000	0	1,294	1,294	1,287	9.24	9.24	9.19
16,100	16,100	0	1,820	1,820	1,785	11.30	11.30	11.09
18,900	18,900	0	2,552	2,552	2,448	13.50	13.50	12.95
21,000	21,000	0	3,125	3,125	2,946	14.88	14.88	14.03
23,100	23,100	0	3,718	3,718	3,444	16.10	16.10	14.91
25,200	25,200	0	4,331	4,331	3,941	17.19	17.19	15.64
27,300	27,300	0	4,964	4,964	4,439	18.18	18.18	16.26
28,000	28,000	0	5,179	5,179	4,605	18.50	18.50	16.45
35,000	35,000	0	7,458	7,458	6,264	21.31	21.31	17.90
42,000	42,000	0	9,961	9,954	7,923	23.72	23.70	18.86
49,000	49,000	0	12,688	11,613	9,582	25.89	23.70	19.56
56,000	56,000	0	15,606	13,272	11,241	27.87	23.70	20.07
70,000	70,000	0	21,486	16,590	14,559	30.69	23.70	20.80
77,000	77,000	0	24,426	18,249	16,218	31.72	23.70	21.06
84,000	84,000	0	27,366	19,908	17,877	32.58	23.70	21.28
91,000	91,000	0	30,306	21,567	19,536	33.30	23.70	21.47
98,000	98,000	0	33,246	23,226	21,195	33.92	23.70	21.63
105,000	105,000	0	36,186	24,885	22,854	34.46	23.70	21.77
112,000	112,000	0	39,126	26,544	24,513	34.93	23.70	21.89
350,000	350,000	0	139,086	82,950	80,919	39.74	23.70	23.12

280. The differences in taxation between the schedular model and the extended tariff are apparent from the Tables 27 and 28. Table 27 assumes that the total of profit is equal to the return component. Table 28 shows what happens if the return component and earnings component are equal.

281. It will be seen that the extended tariff is identical to the progressive one up to a threshold value of EUR 12,583 at which the marginal rate of tax is 23.7% and then asymptotically approaches the schedule tariff.

282. The extended rate structure is the better solution and should, therefore, be used: Since it ensures that all capital income is only subject to a maximum tax rate of 25% (including solidarity surcharge).

Table 28. Comparing tax liabilities and average tax rates: Income tax schedule 2005 vs. dual income tax – Return component = Earnings component

Taxable income			Income tax liability			Average tax rate		
Profits	Of which:		Tax rates 2005	Dual income tax		Tax rates 2005	Dual income tax	
	Return component	Earnings component		Schedular model	Extended tax schedule		Schedular model	Extended tax schedule
Euro			%					
0	0	0	0	0	0	0	0	0
2,800	1,400	1,400	0	0	0	0	0	0
7,000	3,500	3,500	0	0	0	0	0	0
7,664	3,832	3,832	0	0	0	0	0	0
10,000	5,000	5,000	398	398	398	3.98	3.98	3.98
15,328	7,664	7,664	1,624	1,624	1,602	10.59	10.59	10.45
15,400	7,700	7,700	1,643	1,643	1,619	10.67	10.67	10.51
19,600	9,800	9,800	2,741	2,682	2,614	13.98	13.68	13.34
23,800	11,900	11,900	3,920	3,613	3,609	16.47	15.18	15.16
28,000	14,000	14,000	5,179	4,612	4,612	18.50	16.47	16.47
32,200	16,100	16,100	6,520	5,635	5,635	20.25	17.50	17.50
37,800	18,900	18,900	8,432	7,031	7,031	22.31	18.60	18.60
42,000	21,000	21,000	9,961	8,101	8,101	23.72	19.29	19.29
46,200	23,100	23,100	11,570	9,192	9,192	25.04	19.90	19.90
50,400	25,200	25,200	13,260	10,302	10,302	26.31	20.44	20.44
54,600	27,300	27,300	15,018	11,433	11,433	27.51	20.94	20.94
56,000	28,000	28,000	15,606	11,814	11,814	27.87	21.10	21.10
70,000	35,000	35,000	21,486	15,752	15,752	30.69	22.50	22.50
84,000	42,000	42,000	27,366	19,913	19,913	32.58	23.71	23.71
98,000	49,000	49,000	33,246	24,299	24,299	33.92	24.79	24.79
112,000	56,000	56,000	39,126	28,876	28,876	34.93	25.78	25.78
140,000	70,000	70,000	50,886	38,073	38,073	36.35	27.20	27.20
154,000	77,000	77,000	56,766	42,672	42,672	36.86	27.71	27.71
168,000	84,000	84,000	62,646	47,271	47,271	37.29	28.14	28.14
182,000	91,000	91,000	68,526	51,869	51,869	37.65	28.50	28.50
196,000	98,000	98,000	74,406	56,468	56,468	37.96	28.81	28.81
210,000	105,000	105,000	80,286	61,067	61,067	38.23	29.08	29.08
224,000	112,000	112,000	86,166	65,666	65,666	38.47	29.32	29.32
700,000	350,000	350,000	286,086	222,024	222,024	40.87	31.72	31.72

4 Individual Aspects of Dual Income Tax

4.1 Taxing Changes of Legal Form

4.1.1 Introductory Remarks

283. The proposal to introduce a dual income tax adheres to the principles of tax law as it stands as far as possible, especially when it comes to the field of business taxation. In particular, it retains the traditional dualistic approach labelled by the principles of transparency on the one hand and the principle of separation on the other hand (section 183 pp.).

284. If we treat transparent entities and corporations differently for tax purposes, the tax system must include provisions in case businesses change their legal form or are converted otherwise. Such provisions are contained, conventionally, in the Reorganization Tax Act (RTA) and should remain there, too. The German RTA is governed by the accepted principle of business tax law that businesses should not be obstructed from changing their civil law organisational forms by being burdened with tax. This is particularly true when it comes to continuing their reported figures and obtaining tax breaks or carrying losses brought forward. This should continue to apply in accordance with current law, even under a dual income tax.

285. At the same time, however, we have to consider which new questions arise for reorganisation tax law by splitting the tax rate between the standard return on equity capital and any amounts in excess of that. Individual points to note here are as follows:

- *Once-off taxation* of profits up to the standard *return on equity capital*, which is the aim of dual income tax, must not be impeded by conversion procedures (section 286 pp.).
- We must avoid allowing *room to maneuver* to *exploit the differences in tax* between partnerships and corporations (section 293 pp.).
- We need to remove existing *obstacles* in order to achieve tax neutrality with conversion procedures (section 307 pp.).

4.1.2 Carrying over Standard Return on Equity Capital and Return Allowance

4.1.2.1 Tax Neutrality of Conversion

286. To ensure the aim of dual income tax that profits are taxed once and once only at the standard return on equity capital, any return components of a transparent entity or return allowances of shareholders in a corporation must not be lost in conversion. Instead it must be possible to carry them over to the new legal form. On the other hand, it must be remembered that return allowances for corporations are based on shareholders' holdings and, for transparent entities, on their individual tax accounts. The principles which can be used are as follows, depending on which direction conversion is made:

- If a *transparent entity* is converted to a *corporation* and if the owners or partners have *still unused return components*, these may be used after converting (along with the additional return allowances from shares in the corporation after the conversion) to shelter the corporation's dividends or capital gains before income tax. As the costs of acquiring the shares are equal to the transparent entity's equity capital in case of a basis rollover, the standard return on equity capital that is carried over ensures that the profits transferred to the corporation are not overtaxed.
- The procedure for *converting a corporation to a transparent entity* is similar. Carrying over book values can result in profits due to basis carryover, which are similar to capital gains from an economic point of view. Any *unused return allowances* from the shares which cease to exist must, therefore, be applied first and foremost to protect those profits from income tax wholly or in part. Should the unused return allowances exceed these profits, they must be applied (once again together with the return components created in the transparent entity after conversion) to protect profits from the transparent entity accruing to the proprietors from income tax in full.

4.1.2.2 Differences Between the Return Component with Transparent Entities and Return Allowances with Corporations

287. When converting and carrying over unused return components or allowances, it must be borne in mind that, in the case of a partnership, the return on equity capital is calculated at the standard rate of return, i.e. a gross return, whereas the return allowance for shareholders in a corporation, while based on the same standard rate of return, also assumes corporation tax at 25%, thus, creating a net standard rate of return. To convert return components from partnerships to return allowances for shareholders of corporations, we must, therefore, multiply them by the tax factor $(1 - 0.25)$ whereas return allowances must be converted to return components by dividing them by $(1 - 0.25)$.

288. Should profits suddenly soar in any one year, the dual income tax system may create differences in taxation between transparent entities and corporations since the standard rate of return on equity capital for transparent entities is calculated at the gross rate, but that for corporations at the net rate. These differences are structurally similar to those in taxing coupon bonds and zero bonds held by private investors for income tax purposes.

Example 27: A transparent entity has an equity capital of 1 unit at the start of Year 1, does not make a profit in Years 1 and 2, and makes a profit of $(1 + i)^3 - 1$ in Year 3. At the end of Year 3, it can use a return on equity capital of $(1 + i)^3 - 1$. The standard rate of return (gross) and capital market interest rate are the same and referred to as i . The total profit is then taxed as capital income at a rate of 25% in Year 3.

A corporation with the same capital making the same profits, where the cost of acquiring the shares of 1 unit appear at the start of Year 1, distributes $[(1 + i)^3 - 1] * (1 - 0.25)$ after corporation tax. The return allowance at the end of Year 3 is $(1 + r)^3 - 1$, where $r = i * (1 - 0.25)$ is the net standard rate of return. The tax paid is then as follows: Income tax on profits of the transparent entity $[(1 + i)^3 - 1] * 0.25$, corporation tax on corporation's profits is $[(1 + i)^3 - 1] * 0.25$ and income tax on dividends is $0.25 * \{[(1 + i)^3 - 1] * (1 - 0.25) - [(1 + r)^3 - 1]\}$.

289. As Example 27 shows, the profits after tax are only identical if the dividends from the corporation are not subject to income tax. If dividends are subject to tax, the dividend tax only disappears if the return allowance is compounded up at the gross rate of return.

290. If the transparent entity in Example 27 converts to a corporation at the start of Year 3, the unused return component at the standard rate of return i must be converted to a return allowance by deducting corporation tax at 25%: $[(1 + i)^2 - 1] * (1 - 0.25)$. By the end of Year 3, this amount will have increased to $\{1 + [(1 + i)^2 - 1] * (1 - 0.25)\} * (1 + r) - 1$, as the capital of 1 unit and the return allowances must be compounded up at the net standard rate of return r ; because to the cost of acquiring the shares of 1 unit (basis carryover), we have to add a return allowance after conversion at the net rate of return at the end of Year 3 of r . In other words, we do not get exactly the deduction of $(1 + r)^3 - 1$ which would be deducted had the business been founded as a corporation with a capital of 1 unit in Year 1.

291. If the corporation in Example 27 is converted to a transparent entity at the start of Year 3, the unused return allowance based on the net rate of return for tax purposes r must be converted to a return on equity capital at the standard rate of return $[(1 + r)^2 - 1]/(1 - 0.25)$. As the capital of 1 unit and the return allowances must be compounded up once converted at the gross standard rate of return, the return allowance at the end of Year 3 is $\{1 + [(1 + r)^2 - 1]/(1 - 0.25)\} * (1 + i) - 1$; since if the cost of acquiring the shares is 1 unit (basis carryover), a return allowance after conversion will be added at the end of Year 3 at the gross standard rate of return for tax purposes i . Once again, therefore, we do not get precisely a return

on equity capital of $(1 + i)^3 - 1$, which would be deducted had the business been founded as a transparent entity with a capital of 1 unit in Year 1.

292. Converting the unused return components to return allowances and vice versa at the time of conversion does not, therefore, always mean that future profits would be taxed as they would have been had the business been operated in the legal form to which it is converted from the start. On the other hand, there is no reason to overcome these tax differences if a business is converted. In fact, this outcome is compatible with the aim of leaving taxpayers free to choose what legal form they wish to use and not to make it more complicated for them to switch by taxing earnings or easier by giving tax relief.

4.1.2.3 Tax-Saving Constructions?

4.1.2.3.1 Switching Between Partnerships and Corporations

293. Dual income tax could provide an incentive to *convert a corporation to a transparent* entity to increase the equity capital base relevant for computing the standard return on equity. That would be the case if the historical cost of acquiring the shares were low and if there were hidden reserves in the corporation's business assets. At the same time, converting could be used to increase book values enabling more profits to be taxed at the proportional rate of 25%. If the assets at the transferring corporation are valued at fair value, converting the corporation to a sole proprietorship would be taxed as if winding it up. Therefore, dual income tax does not provide any additional incentive to convert in this case. All hidden reserves would then be subject to corporation tax at 25% as transfer profits, and transfer profits must be treated like dividends, i.e. taxed at 25% income tax insofar as they exceed the available return allowance. The outcome is that the dividends are still taxed at $43.75 [= 25 + 25 * (1 - 25)]\%$.

Example 28: For reasons of simplification, equity capital is assumed to be zero in this and the following examples, and we ignore interest effects and untaxed dividends. Individual N holds all the shares in Corporation U, which is converted to a sole proprietorship. U has hidden reserves of 100 units; the cost of acquiring the holding in it is zero. If the assets are valued at fair value, U's transfer profits after 25% corporation tax are 75. N's transfer profits are 75 units, on which an income tax of 18.75 units is due. The sole proprietorship's business assets are set at 100 units, thus, the subsequent inflow of hidden reserves of 100 units does not mean any more income tax is due. The total tax on the hidden reserves is $43.75 (= 25 + 18.75)$, which is equal to the tax on paying the hidden reserves as dividends.

294. If the cost of acquiring a holding in a corporation is close to its market value, one might be tempted to convert a corporation which has hidden reserves at its book value giving a transferee's loss. If this loss could be used for tax purposes, the value of the holding in the corporation being converted could be transferred to the transparent entity's business assets. As there are differences between

legal forms when calculating the profits to be taxed at the proportional rate, it cannot be ruled out that a dual income tax system would cause such conversions. The prohibition on applying a transferee's loss, which is the rule in § 4 para. 5 RTA in Germany, pulls the rug from under such strategies, however.

295. In support of ignoring a transferee's loss, it could also be argued that German corporate groups controlled by foreigners would have an incentive to increase the acquisition costs of holdings in German corporations.

Example 29: For a foreign holding company, one way of increasing the acquisition costs of holdings in German corporations would be to sell shares of a German subsidiary corporation C2 to another German subsidiary corporation, C1. C1 would not use the increased costs of acquiring the shares in C2 directly; but C2 could be converted to a transparent entity at book value. The resulting transferee's loss could then be used to protect profits from taxation which would have been subject to corporation tax had the corporation not been converted.

296. Even if one believes that a transferee's loss should not be immediately deducted or converted to depreciation to avoid creative accounting, one might still consider taxing subsequent profits on disposals at a lower rate up to the value of the transferee's losses on account of the high cost of acquiring the shares (not because the assets acquired have a negative value) by increasing the attributable return component accordingly. This would at least reduce the risk of taxing the hidden reserves twice. While this solution makes sense in system terms, however, it is particularly subject to the reservation of taxpayers trying to use the tax system to their advantage.

297. *Converting a transparent entity to a corporation* could also be considered as a way of increasing the return base, should the transparent entity's business assets include hidden reserves. The cost of acquiring the shares of the corporation would be equal to the equity capital of the transparent entity being converted plus the hidden reserves. Setting its fixed assets at their *fair value*, on the other hand, would mean there is a profit on disposal to be taxed. Thus, there is nothing to be gained in principle by increasing the book value.

Example 30: Individual N operates a sole proprietorship, which is to be absorbed by Corporation U. The sole proprietorship has hidden reserves of 100 units. N's profit on the disposal is 100 units on which income tax is due at 44.31 units. Acquisition costs of the shares in U are 100 units. U's business assets are valued at 100 units realising the hidden reserves of 100 units does not create a profit, and neither corporation tax nor income tax is due on the dividends. The total tax on the hidden reserves is, therefore, 44.31.

4.1.2.3.2 Mergers and Acquisitions

298. Anyone selling a sole proprietorship or holdings in partnerships might be tempted to use the difference between the rate of capital income tax and the (high-

er) progressive rate of personal income tax under § 32 a ITA. Anyone selling a sole proprietorship where no tax relief for profits on disposal is granted will find themselves subject to the top rate of personal income tax at 44.31%.

299. A sole proprietor could, therefore, transfer the business to a corporation at its book value and tax the capital gains on disposal of the share at 25%. Whoever acquires the shares in the corporation will then pay profits after corporation and income tax. Contributing the business at its book value, therefore, has an effect on its price, which this construction counteracts.

Example 31: A sole proprietor has business assets with hidden reserves of 100 units. If he sells his business, the buyer pays 100 units, as the cost of acquiring the business assets is now 100 units realising the hidden reserves of 100 units does not generate any further liability to income tax. The seller pays 44.31 units of income tax on the profit on disposal leaving him with a profit after tax of 55.69 units. If the seller converts the partnership into a corporation at book value before selling it (the cost of acquiring the shares is zero) and later sells the shares in that corporation, how much profit he makes on the disposal depends on how much he can get for them. If the buyer continues the corporation, the most he will pay are the hidden reserves after all taxes plus the tax savings from the reduction in value of the shares. The price is, therefore, $P = 100 * (1 - 0.25) * (1 - 0.25) + 0.25 * P = 75$. The seller pays 25% income tax on the profits of 75 units, leaving him 56.25. Thus, there is little to gain from the conversion.

300. The legislators, on the other hand, want to reduce the apparent benefit of converting first by treating disposing of shares created by way of contribution as an asset deal for a specific period at least. Disposing of them would be subject to tax at the usual rate.

301. If taxing profits via progressive income tax is equal to taxing them with corporation tax and proportional tax on capital income, conversion cannot be used to exploit the difference in tax rates. On the other hand, the buyer could convert the corporation he has just acquired back to a sole proprietorship. Reconversion could be used to step up the book value. Stepping up the book value gives the corporation a transferor's profit. Having converted the corporation, the buyer saves tax through writing down the increased book value governed by the rate of progressive income tax. This reconversion cannot save tax, however.

Example 32: The assumptions are the same as in Example 31 unless the buyer converts the corporation to a sole proprietorship after acquiring it, stepping up its book value. The corporation shows a transferor's profit of 100 units and pays 25 units of corporation tax, which the buyer pays. Its business assets are set at the stepped-up value of 100 units; no income tax is due on the hidden reserves realised. The inflow after tax is, therefore, 75 (100 - 25). The buyer pays $P = 100 - 25 - 0.4431 * (100 - 25 - P) = 75$. Thus, there is nothing to gain from converting the corporation back to a proprietorship.

302. Under the law as it stands, transparent entities can have their book values stepped up when being merged with corporations, which also requires capitalising a self-generated goodwill. Stepping up book values when *converting corporations*, on the other hand, is subject to the restriction that capitalising self-generated intangible assets (including the goodwill) is not allowed. When assets pass from corporations to transparent entities, the tax authorities also assume that they can only be valued at more than book value to a very limited extent because of the principle that tax accounting has to conform to financial accounting principles. All this impedes stepping up book values.

303. Although the level to which book values can be stepped up varies from one kind of conversion to another, the German RTA allows the basic option to set the business assets which change hands at their book value, their fair value or a value between these two (§ 3 RTA). To avoid mechanisms involving stepping up book values, consideration could be given to abolish this option and to insist that *transfers are made at book value only*. The discounted value approach is only required if there is a risk hidden reserves will not be taxed (§ 20 para. 3 RTA). The book value approach also prevents anyone using conversions to exploit differences between corporation and personal income tax rates.

Example 33: A corporation is converted: Its business assets now come under personal income tax. The hidden reserves are no longer subject to corporation tax and the dividends (or capital gains) not to income tax. Instead the hidden reserves come under the progressive rate of income tax, which peaks at 44.31%. In the opposite direction, being taxed at the progressive rate of income tax is replaced by a combination of corporation tax and tax on capital income at 43.75% in total. The conversion itself is made at book values and has no tax effects.

4.1.2.3.3 Using Losses Brought Forward

304. As matters currently stand, losses a corporation carried forward cannot be transferred to a sole proprietor or partners in a partnership. They are lost in conversion. If the fair value approach is only possible to a limited extent, most losses cannot be converted into potential depreciation either. As the fair value approach has generally been replaced by the book value approach, such losses are lost for good. To prevent such losses being lost, the *corporation's losses brought forward* must then be attributed to the shareholders in proportion to their holdings. In that case, using those losses is linked to setting them off against the standard return on equity capital for the transparent entity, which is taxed at 25%.

305. When a transparent entity is converted, any losses the business is carrying need not to be transferred to the corporation. Those losses remain with the sole trade or partner of a partnership, who can use them in accordance with the general rules. If loss compensation was limited to equity contribution, this can be continued even after converting to a corporation accordingly, which is why offsetting such losses is only possible against future taxable dividends or capital gains.

306. In conclusion, we can say that transferring assets at book value prevents any constructions aimed at increasing the return base for tax purposes by way of conversion. Acquisition losses must continue to be ignored, however, to combat such structures. Whether transferring assets at book value becomes the rule or not, corporations should be able to transfer their losses to their shareholders if they are converted.

4.1.3 Removing More Obstacles to Conversion

307. Transferring assets at book value calls for improvements in tax neutrality when converting partnerships to corporations where the contributor is subject to unlimited tax liability.¹⁰⁶ At present hidden reserves are only tax-exempt if all the fixed assets which constitute a business or part of it are injected into the corporation (§ 20 para. 1 RTA). This also includes business assets owned by a partner and used by the partnership on the basis of a contractual relationship (so-called separate business property, *Sonderbetriebsvermögen*). This means that, under the law as it stands, there is no way of allowing a corporation to use an asset which a shareholder's partnership could use once the corporation is converted without taxing the hidden reserves. This could discourage partnerships from converting.

308. To overcome this obstacle, the book values of the former separate business property must be continued without transferring them to the corporation. These assets are then caught up in the web of income tax. The shareholder must pay tax on such assets as if they were profits from a sole proprietorship. This includes that profits up to the standard rate of return are taxed at a maximum rate of 25%. Taxing these assets as part of private asset management must be seen in the context of taxing income from rent and lease (section 310 pp.). Implementing these proposals in law would be a two-stage process:

- Withdrawals are to be shown at book value if the assets withdrawn are used to obtain income from financial assets or real assets.
- Assets can be contributed without triggering income tax if business assets are left in the separate business property.

309. There is another tax obstacle to conversion: *real property transfer tax*. Real property transfer tax applies to all conversions other than changes of form and is governed by a standardised tax value of the land (*Bedarfswert*). For an organisation to pay real property transfer tax merely because it changes its civil law organisation form is as inappropriate as paying taxes on hidden reserves. We cannot see any economic reason why the exemption should be limited to changes of legal form: Real property transfer tax should not apply to any conversions of any kind.

¹⁰⁶ If the contributor is subject to limited tax liability, the proposed dual income tax provides that business assets contributed continue to be valued at their fair value as far as the corporation is concerned.

4.2 Rent and Lease

310. Under dual income tax the existing dualism of different kinds of income in Germany, i.e. the coexistence of income assessed either on the basis of profits or on the basis of cash flows, basically disappears. Instead anything that mainly involves employing capital is treated the same in tax terms. Concerning income from capital assets, this has already been discussed in connection with taxing dividends and capital gains. Likewise, income from *rent and lease* should be taxed, in principle, similar to income from *business activities*. Owner-occupied properties, on the other hand, continue to be generally non-taxable.

311. When leasing property for residential or commercial purposes, we must, therefore, ensure that the income involved (usually rent) is taxed as *capital income* at the *preferential tax rate* for *standard return on equity capital* at not more than the rate proposed for this of 25% while any additional income is subject to income tax at the progressive rate. The intended aim of reducing the tax on the standard rate of return on capital, therefore, means we have to rely on accrual accounting when it comes to using real assets. Seen from this perspective, *realised changes in value* of assets (profits and losses on disposing of them) are *generally relevant for income tax purposes*.

312. At present there is a major difference between how income from rent and lease is taxed on the one hand and how profit income is taxed on the other. Once beyond the ten-year anti-speculation period under current German income tax law, profits and losses on disposals in connection with income from real assets are not taxable (§ 22 para. 2 in conjunction with § 23 para. 1 no. 1 ITA). They come under non-taxable income from private asset management. Depreciation and interest expenses, however, can be deducted when calculating rent and lease income. When capital gains are calculated at a later date, depreciation which was deductible when determining income has to be deducted from acquisition or production costs (§ 23 para. 3 ITA). On the other hand, there is no accrual accounting, which under dual income tax would be a major requirement for calculating the rate of return on equity capital. Making such accrual accounting obligatory for all real assets used to generate income would create considerable administrative problems. While let or leased properties can have their acquisition or production costs and wear and tear allowed against them, there are considerable problems with how changes of value of real assets are seen for tax purposes, especially in cases of writedown to fair value or write-up, or even the acquisition cost for old properties that are already past the 10-year mark if accrual accounting were introduced. When it comes to recording profits and losses on disposals on *assets that were not yet subject to tax* – land and buildings –, we have to ensure that only those changes in value are included for tax purposes which have happened since dual income tax was introduced. This means that the assets are valued at their *market values at the time of conversion* to dual income tax. This includes any assets acquired (or, in the case of buildings, made) outside the 10-year anti-speculation pe-

riod. Valuations could be based on valuation committee reports or those by other authorised experts. As the assets in question were already taxable before dual income tax was introduced, the impact of disposals must be based on book values or extrapolated acquisition or production costs. The values involved are generally known. This includes assets of what are presently private estates acquired within the existing 10-year anti-speculation period in § 23 para. 1 no. 1 ITA and assets classified as business assets including separate business property in the case of partnerships, which under dual income tax can in principle be withdrawn at book value. Disposals and ceasing to let are, therefore, taxable.

313. These administrative difficulties are by no means peculiar to dual income tax: They generally apply whenever considering how to tax changes in value of assets employed in leasing. On the other hand, we have to admit that including income from rent and lease immediately and universally in a dual income tax system at the time this system is introduced is faced with *administrative obstacles*. One might, therefore, consider making extending the rules on return on equity capital for transparent entities to income from rent and lease dependent on the taxpayer applying for this. That application would put the taxpayer in an accrual accounting comparison which, on the one hand, could be used as the basis for applying the proportional preferential rate of tax but would also mean that any increases or decreases in value of the taxpayers real assets portfolio beyond the 10-year period of § 23 ITA would be fully included for tax purposes. By combining these beneficial and adverse tax effects in a single option, this could make it easier for property owners to switch to recording their profits on disposals in full.

4.3 Re-Organising ‘Other Income’ (§ 22 ITA)

314. While it appears from all this that the idea of a dual income tax system can be reflected in the existing system of different sources of income, whether it be directly in the case of income from labour and income from private asset management or in the case of business income by calculating a profit split based on a theoretical rate of return, ‘other income’ as defined in § 22 ITA needs drastically reallocating.

315. This is less about the circumstances in § 22 para. 1 nos. 2 to 4 ITA, which can be allocated either to capital income (nos. 2 and 3) or income to be taxed at the standard rate (no. 4). Where the problem really lies is the complex of rules on recurring payments including pensions under § 22 para. 1 no. 1 und 5 ITA, insofar as adhering to the type of inflow as defined in law stands in the way of treating them properly for tax purposes using the standard of a divided definition of income which is an essential feature of dual income tax.

316. On the other hand, this merely exposes a conflict of principles already inherent in the law as it stands in the light of the new system decision to be made

under dual income tax, which must be congruently designed on constitutional grounds. As it is seen by the overwhelming majority of scholars and in case law, income tax law is based on the idea that a taxpayer's taxable income solely consists of the income that has actually be earned. A mere reimbursement of capital, on the other hand, being a kind of regrouping of assets is only to be seen as taxable income insofar as it either contains a return on capital or, if we move away from the periodicity principle of taxation in private asset management as well – as is suggested here –, at least an accretion. These principles are in conflict with the idea, based on the concept of consumption fund theory, that it is the outward form of the inflow in itself that justifies imposing tax. Supreme Court case law has moved increasingly away from this idea in the past¹⁰⁷ by regarding recurring payments received in the course of a barter transaction either as capital income (§ 20 para. 1 no. 7 ITA)¹⁰⁸ or, in the case of ongoing charges, by separating out a return component subject to tax alone.¹⁰⁹

317. It will be clear from this that this conflict of principles is a methodological problem of rule priority in the first place and can also be resolved as such. If and insofar as recurring payments are obtained, i.e. consideration is given for those, they are ultimately taxed as income under § 2 para. 1 nos. 1 to 3 ITA draft. Thus, it may only be argued about what source of income is concerned in each particular case. Pension receipts can be merely stated by way of example here. They are taxed under the rules for taxing capital or earnings income depending on whether they are classified as consideration for labour provided or as capital gains on investing wages already received.

318. If recurring payments obtained are excluded from the category of other income via a rule of prior application, the second conflict of principles comes into view in the shape of how those recurring payments are actually defined. This concerns the idea of what is known as the market income theory and the subject tax concept on the one hand and being guided by a coherent view of ability to pay on the other hand in the special case of services not for reward. This conflict can be expressed as the question as to whether and insofar as the requirements of the objective (§ 4 para. 4 and § 9 para. 1 ITA) or subjective (§ 10 para. 1 no. 1a ITA) net principle call for taking into account the expenditures of a person in favour of a third party; at the same time a holistic approach allows us to record these benefits obtained on the recipient's part unless there are circumstances on their part which rule out being taxed. The same question arises if the law takes certain attributes in the person who realises the earnings as reason not to tax them.

319. The law as it stands resolves this conflict by taking the approach of the concept of an interpersonal principle of correspondence (§ 22 para. 1 clause 2 first

¹⁰⁷ Cf. also BFH 29.3.1962 - VI 105/61 U, BStBl. III 1962, 304.

¹⁰⁸ See BFH 25.6.1974 - VIII R 163/71, BStBl. II 1975, 431; 26.11.1992 - X R 187/87, BStBl. II 1993, 298.

¹⁰⁹ See Fundamental BFH 28.6.1963 - VI 321/61 U, BStBl. III 1963, 424.

sub-clause ITA). If the law allows for reduced ability to pay on the giver's part, this is only the case as far as their personal circumstances justify doing so. This capacity is exhausted correspondingly on the receiver's part. It is proposed to introduce this principle of interpersonal transfer of ability to pay as a fundamental systematic decision. In terms of recurring payments, this also reflects the need for a special institute to adequately deal with business succession rules for tax purposes ('handing over assets in return for pension services').

320. If we propose such a principle of correspondence, terminology needs to be harmonised accordingly. The concept of ongoing charges in § 9 para. 1 clause 4 no. 1 and § 10 para. 1 no. 1a ITA should be replaced by that of 'recurring expenditures', for example.

321. The concept of a corresponding tax treatment for recurring expenditures and payments can be extended to include the special taxation method for postponed taxation introduced with the old-age income law. If expenditure on pensions is allowed against tax in the so-called 'savings phase', the inflow in old age must be taxed in full accordingly. We might call this an intra-personal transfer of ability to tax over time. This justifies including the circumstances of § 22 para. 1 clause 3 lit. a double letter aa and no. 5 ITA in the scope of 'derived income'. While taxing income in old age on a deferred basis is incompatible with the concept of a dual income tax, it must be accepted as a special provision by the legislators.

322. This means that of the set of recurring payments there remains only the circumstances of § 22 para. 1 clause 3 lit. a double letter bb ITA, which concerns life annuities which are either based on private law pension rights or fully taxed contributions and inflows from non-subsidised pension contracts under § 22 para. 1 no. 5 clause 3 ITA. Seen in systematic terms, these are pre-taxed capital income which has to be divided into an interest component and an asset base. The correct place for dealing with these for tax purposes is, therefore, § 20 ITA. On the other hand, it would be advisable to respect the law's lumping when calculating the earnings component, excluding actuarial methods as has been reflected to date in the table for § 22 para. 1 clause 3 ITA (§ 20 para. 1 nos. 3 und 3a ITA draft), and also not to question the changes which were recently made to taxing pension income¹¹⁰ substantively again, to preserve continuity in law.

¹¹⁰ See old-age income law of July 5, 2004, BGBl. I 1427.

4.4 Levying Tax on Capital Income

4.4.1 Benefits of Uniform Taxation of Capital Income

323. As far as taxing private capital income is concerned, most of the current enforcement problems stem from the fact that the rules for taxing interest, dividends and capital gains are different. More recent capital investment products and financial innovations are virtually impossible to define in terms of current taxation categories and exacerbate existing problems of drawing the line between taxable and non-taxable income. Closing tax loopholes, precisely in taxing capital gains, means private tax planning is no longer worthwhile while at the same time making it easier to enforce tax. Finally, a moderate rate of income tax reduces the incentives to earn capital income abroad.

324. Politicians and tax authorities alike have long been aware of these problems. The CDU, CSU and SPD's coalition agreement of November 2005 proposes to revise how capital income and capital gains are taxed within the current legislature period.¹¹¹ The Hessian's Ministry of Finance presented proposals for uniform taxation of interest, dividends and capital gains in 2005.¹¹²

325. The dual income proposals presented here also provide for comprehensive taxation of capital income – interest, dividends and capital gains exceeding the return allowance – at a single rate of 25%. Dual income tax goes even further, however, by linking taxing capital income to taxing businesses. As business profits are also taxed at 25%, insofar as they count as capital income, final withholding tax on capital income and business tax form a single unit. The proportional tax of 25% applies no matter how capital is invested, which ensures that taxing business is largely neutral in terms of finance and legal form.

4.4.2 Final Withholding Tax with Assessment Option

326. Under the dual income tax system as proposed, tax on private capital income can be levied largely via an anonymous final withholding tax system. There are two aspects to be addressed here:

- The proportional tax rate on capital income as proposed is linked to the tax rate on corporate profits to ensure neutrality in terms of legal form and finance, provided business profits count as capital income. This rate of tax cannot presumably be less than 25% at present for revenue reasons. Thus, the difference between this flat tax on capital income and the basic rate of income tax including solidarity surcharge in Germany is nearly 10% ($25 - 15.825 = 9.175$). The

¹¹¹ See Coalition Agreement (2005: 69).

¹¹² See Hessian Ministry of Finance (2005).

constitutional requirements of the objective and subjective net principle must be met as well, which means that any final withholding tax must be combined with an *assessment option* in the taxpayer's favour, precisely at lower income levels. Taxpayers are likely to use this assessment option in cases where they wished to claim relevant business expenses against tax, where they can deduct personal or family subsistence costs and other private deductions or use the progressive rate schedule below 25%. It may be assumed that the number of taxpayers using this assessment option would be few (sec. 45b ITA draft).

- Making taxation neutral in terms of legal form and finance, which is an important aim of dual income tax, also means that, when assessing income from equity investments (dividends and capital gains), the taxable base must be reduced by the *return allowance*.¹¹³ The return allowance is tied to the underlying shares as was stated in section 136 pp. The custodian financial institutions must calculate and adjust it between periods on an annual basis. If a share is disposed of, leaving an 'exceeding' return allowance not applied, this allowance is lost and must be cancelled along with the shares.

327. For the many cases where capital income is obtained with the involvement of a domestic financial institution, a final withholding tax with assessment option would, thus, allow for devolving the administrative efforts into those financial institutions. They have the required information to handle the taxation (i.e., the date of acquisition and disposal, historical costs and selling price in the case of shares and date and amount of interests paid for debt stocks).¹¹⁴ In the vast majority of cases, taxpayers would be relieved of the burden of declaring their capital income. On the other hand, tax authorities would still be involved in the process of assessing private loans, dividends from and disposals of unquoted shares in corporations (especially *GmbH*) and in all cases where the custodian institution and, hence, the payment office are located abroad. Even with a final withholding tax with assessment option, tax authorities would still have the job of levying tax; only the number of cases they have to deal with would be likely to fall drastically.

328. If private capital income is paid out via a domestic financial institution under the dual income tax system, tax would be collected by the financial institutions as before for the reasons given above as *withholding tax* or *capital gains tax* at source, passed to the tax authorities and confirmed to taxpayers in their annual tax certificates. Customers would only receive net payments. Custodian financial institutions in Germany would also be bound to calculate the return allowances for individual investment stocks on an annual basis and adjust them as well. This applies even if a portfolio forms part of business assets. With capital income from return on equity from transparent entities, private loans, shares in non-quoted corporations and assets held abroad – this covers taxpayers subject to unlimited liability to tax and, to a limited extent, whose custodian financial institutions are abroad – tax is exclusively assessed by the competent tax authorities. In these cases, tax-

¹¹³ See section 100 pp.

¹¹⁴ See section 329 pp.

payers must calculate and prove their own assessment bases themselves. On the other hand, provisions should be made to enable debtors to retain capital gains tax on income under § 20 para. 1 no. 1, 2 and 4 ITA where the underlying rights are not certified, as with GmbH shares, e.g., or the custodians are located abroad.

329. In the final instance, therefore, the administrative work involved for German financial institutions and for tax authorities would slightly increase. On the other hand, both would be freed from the ‘exemption procedures’ practised at present. Most taxpayers could avoid an assessment with all the records, returns and evidence involved, however.

4.4.3 Determining and Levying Tax

4.4.3.1 Tasks of Financial Institutions

330. Private capital income paid out via payment offices in Germany is subject to a flat-rate *capital gains tax at 25%*. The financial institutions involved calculate the receipts liable to capital gains tax, just as under current law. As capital gains will also be taxable in the future, any conflicts about the qualification as taxable or non-taxable income will disappear making tax enforcement simpler. Under dual income tax, financial institutions will also have to calculate the return allowances on shares. For each class of shares, this *return allowance* can be calculated precisely to the day based on when shares are acquired and disposed of, by multiplying the acquisition cost (purchase price, including ancillary costs and commission) and the after-tax rate of return established.¹¹⁵ Calculating return allowances, thus, also affects the capital gains tax withheld. In principle *capital gains tax* is based on the *gross receipts* in each case for all categories of a taxpayer’s private capital income (interest, dividends and capital gains); the gross amounts are reduced by the accrued returns allowances for those capital assets only with income from holdings. Annual custodian costs can also be deducted at this level.

331. Should any of their clients opt for an assessment, the financial institutions will issue an *annual tax certificate* on demand stating:

- how much tax has been withheld;
- the total private capital income on which tax was withheld;
- return allowance;
- losses on disposals;
- advertising costs (such as custodian charges).

If taxpayers exercise the assessment option, this certificate will allow them to state their return allowances and other items as stated.

¹¹⁵ See sections 136, 140. If the initial standard rate of return is 6%, as suggested here, and the single rate of tax on capital income is 25%, that gives a standard rate of return after tax of 4.5 [= (1 - 0.25) * 6] %.

332. To calculate the return allowances as well as the capital gains obtained from the disposal of shares in corporations, the latter have to be recorded at their time values or stock market values as of January 1 of the year of implementation. These values are then taken as historical costs for determining the return allowance and all subsequent disposals. Where capital gains are already subject to tax under current tax rules in Germany, e.g., if they are acquired within the 12-month period (§ 23 ITA) or for tainted shares, the original historical costs or book values must be used. With portfolio investors, on the other hand, consideration could be given using the market prices as of January 1 of the year of implementation for reasons of simplification. New share values would not have to be determined each year; adjusting return allowances would suffice.

4.4.3.2 Tasks of Tax Authorities

333. As at present tax authorities would have to allow for capital gains tax withheld when making their assessments. Where capital earnings exceed proven return allowances (which are also taken into account when applying capital gains tax), the process ends when the capital gains tax withheld is deducted from the income tax at the appropriate rate or when capital gains tax is refunded. Including advance tax on corporations the rate is, therefore, capped at 25%.

334. In the case of private loans, dividends and profits on disposals of non-quoted shares in corporations, taxpayers would have to determine the tax base required by them, including the annual return allowance, and inform their local tax office accordingly. Here, it is the taxpayer who adjusts the return base; the tax office only checks to see if it is correct.

4.4.3.3 Matters Involving Abroad

335. Where *taxpayers are subject to unlimited liability to tax*, the custodian financial institution may also be situated abroad. Private capital income then is also liable to the flat rate tax of 25%. In these cases, the home state tax office handles the taxation imputing the source tax paid abroad. It is up to the taxpayers to calculate and prove their tax basis. Where no tax was withheld at source abroad and no information is exchanged with the German tax authorities, the existing incentives to disguise capital income earned abroad from the tax authorities will remain; but the incentives to evade tax on capital income will presumably be reduced if Germany only taxes it moderately thanks to the low tax rate and return allowance on dividends and capital gains.

336. Where taxpayers are subject to *limited liability to tax* on private capital income, dual income tax means changes to capital gains tax on dividends.¹¹⁶ To

¹¹⁶ If there is a double taxation treaty with the state in which a foreign investor is domiciled, the right to tax capital gains will normally rest with that state. Capital gains go-

avoid discriminating under EC law, the assessment base for capital gains tax on dividends must also be reduced by a return allowance if those receiving the dividend are resident elsewhere in the EU. The details required to cut capital gains tax, and the return allowance in particular, must be proven to the Federal Tax Office concerned. Tax authorities can call on the EU's Directive on Mutual Assistance when assessing details. Applications to reduce the assessment base for capital gains tax by a return allowance will presumably be limited. As private capital income is generally subject to income tax in the state where the recipient is resident, there would generally be no substantive advantage in moderating German capital gains tax unless this avoids excessive imputation.

4.5 Dealing with Losses

4.5.1 Background Conditions

4.5.1.1 Significance of Loss Offsetting

337. With a tax concept such as the variant of a dual income tax as proposed here, the subject of loss offsetting is, of course, of great importance. The problems are, on the one hand, that provisions dealing with loss offsetting should be in line with the objective of a *decision-neutral tax system*. This calls for losses to be largely capable of being offset inter-temporally against different types of income. On the other hand, *differentiating between different sources of income* in terms of the tax rate to be applied is one of the key features of dual income tax.

338. Firstly, from the standpoint of *improving decision neutrality of a tax system*, it should be borne in mind that rules on offsetting losses do not distort investment decisions. Whether and in what form entrepreneurs decide how to invest also largely depends on the extent to which the tax authorities share not only in entrepreneurial success but also in the adverse effects of failed investments. Thus, the objective of neutrality demands that the tax system symmetrically deals with profits and losses as far as possible in this respect.

339. Secondly, dual income tax is based on a *schedular concept of income*. This is reflected in the systematic distinction between earnings income and capital income. On the other hand, dividing income this way is primarily about what rate is to be used and less about how the assessment base is arrived at. Thus, netting

ing to those liable to limited tax are, therefore, typically tax-free in Germany and must not be reduced by a return allowance.

losses between the two sources of income must be permissible in principle. What needs to be prevented is tax planning using different tax rates.

340. When it comes to actually designing the tax rules on netting losses, that means that, first, any kind of *minimum taxation* must be avoided – insofar as this appears reasonable in fiscal terms – and, second, – looking at the total investment period as a whole – any losses not offset in individual assessment periods can be *netted as promptly as possible*.

4.5.1.2 Constitutional Framework

341. But being economically appropriate is only one of the background conditions we have to take into account when designing loss netting rules. At the same time – although the circumstances may well often overlap – we must also consider the requirements of constitutional law that imposes considerable restrictions on the tax legislator’s scope for design, particularly by specifically applying the rule of equality of taxation as the *objective and subjective net principle*.

4.5.1.2.1 Objective Net Principle

342. The objective net principle is the key to considerations when it comes to dealing with losses. In its general version, it demands that business costs incurred in obtaining an income are to be considered, even if they exceed those earnings, that is if a loss arises. German tax law embodies the net principle understood in this way at a number of stages in the process of determining income. In what follows below, these stages will be used as the conceptual guidelines in presenting the various mechanisms of loss offsetting under a dual income tax:

- When calculating income on the first stage, i.e. the single sources of income, business expenses or advertising costs can be offset against income (§ 4 para. 4, sec. 9 para. 1 ITA).
- When calculating income within an assessment period, the rules of horizontal and vertical loss offsetting apply (§ 2 para. 3 ITA).
- Finally, in an inter-temporal context, losses can be deducted by way of carrying them back or forward (§ 10d ITA).

343. The legislators have applied, and do apply, many *restrictions* in terms of netting losses, not least to safeguard tax revenues. Intra-period *minimum taxation* under § 2 para. 3 ITA (old version) may have been abolished (and with good reason) by what is known as the ‘*Basket II Act*’¹¹⁷; but deducting losses across periods is still subject to maximum limits (§ 10d ITA). As well as these quantitative limits, under the law as it stands, *vertical loss netting* also imposes time limits on certain income sources (e.g., in §§ 2a; 15 para. 4; 15 b; 22 no. 3 clause 3; 23 para.

¹¹⁷ Cf. the law enacting the Federal Government’s protocol declaration on the mediated recommendations on the tax concession abolition law of December 22, 2003, BGBl I 2003, 2840.

3 clause 8 f. ITA). This is a finding which is of particular interest to a dual income tax, which elevates treating income on a schedular basis to a real system. From a constitutional law standpoint, the often debated question arises as to whether the objective net principle can be sufficiently met simply by way of a chronological loss netting within a given source of income alone or whether the rule of equality of taxation requires that losses be nettable vertically in principle except insofar as particular grounds for justification, such as averting abusive tax planning, undermine the principle of setting off losses.¹¹⁸ There are good reasons to believe that setting off losses is a constitutional right but the constitutional court's attitude on this point is still unclear. The only thing we can say with reasonable certainty is that ruling out offsetting losses is completely unlawful.¹¹⁹

4.5.1.2.2 The Subjective Net Principle

344. The subjective net principle ultimately means that income must be left untaxed up to a subsistence level.¹²⁰ This rule argues against any kind of minimum taxation which would constitute a tax claim even if the taxpayer would not have enough to survive on in any case or after paying their tax bill.¹²¹ The Federal Constitutional Court has not made any statements which can be relied upon on this matter either.

345. These additional requirements to loss offsetting must be particularly taken into account when designing loss absorption rules under a schedular dual income tax system. It proves to be particularly relevant when setting off negative capital income against positive earnings income and vice versa.

4.5.2 Setting Off Losses when Calculating Income

346. Any systematic survey of the rules on absorbing losses with Dual Income Tax – and, hence, with any kind of dual income taxation – must start with the smallest tax unit, i.e. income from a specific source. If income is calculated as profits by balance sheet accounting (which means especially in cases of business income but also at the taxpayer's option in cases of income from real assets), allocating income amongst the various sources means dividing profits into a 'return component' and an 'earnings component' (section 217). This split is in line with the taxable net profits obtained using the usual rules of accountancy. Income, therefore, continues to be calculated on a comprehensive basis, that is irrespective

¹¹⁸ See, e.g., BVerfG 30.9.1998 - 2 BvR 1818/91, BVerfGE 99, 88, 97.

¹¹⁹ See BVerfG 30.9.1998 - 2 BvR 1818/91, BVerfGE 99, 88

¹²⁰ See BVerfG 29.5.1990 - 1 BvL 20, 26, 184 and 4/86, BVerfGE 82, 60, 85; BVerfG 25.9.1992 2 BvL 5, 8, 14/91, BVerfGE 87, 153, 169 f.; BVerfG 10.11.1998 - 2 BvL 42/93, BVerfGE 99, 246, 259 f.

¹²¹ See the BFH's preliminary ruling 7.7.2004 - XI B 231/02, DStR (2004, 2139) on the minimum taxation under § 2 para. 3 ITA pp.

of what the source of income concerned actually is. The schedular element which is the hallmark of dual income tax is of no significance at all when determining income but only when it comes to the question of how profits are to be allocated between the various categories of income defined as return or earnings components.

347. The first ‘setoff’ already occurs in the fact that the proposals presented do not tax any return component from a positive return base if and insofar as a business’s total profits are less than the ‘return component’ for the assessment period in question. In other words: There is no tax on the standard return on equity capital. A second ‘setoff’ can be traced in that *debt interest and capital losses in particular*, which fall within the scope of the operating unit, does not only reduce the profit component to be taxed at a low rate as attributable return component but profits as a whole including the earnings component. This means that there is *no gross taxation* of profits income for the case that debt interest and capital losses exceed the standard return on the (eligible) assets. If the *return component is negative*, this has no impact at all on the tax bill in the year in which it arises. It is simply carried over to subsequent assessment periods along the lines of § 10d ITA reducing any return components which may arise in those periods (section 247 pp.).

4.5.3 Setting Off Losses Horizontally

4.5.3.1 Profit Income

348. There is a step further, ‘setting off losses horizontally’, which is used between different sources of income within the same kind of income. As dual income tax puts different elements of profits (earnings and return components) in different categories of income, this also means reorganising setting off losses horizontally. Consequently, it is no longer possible to set off business income without any restrictions in a single arithmetical option. Instead this is divided into a number of stages. The first step is to make a set-off possible in the first place insofar as the income (from different businesses, for example) falls into the same category of income. One particular feature which has to be considered is the allocation rule of our proposal whereby with businesses a negative operating result is attributed to earnings income but negative income from real assets to capital income as a whole. Set-off between different categories of income is only enabled at a later stage (see section 350 pp. and below).

349. For the avoidance of doubt, it should be noted that setting off losses between businesses or real estate within a given source of income should not be confused with setting off ‘return components’, that is proportionally taxed profit components. Such return components (being positive or negative depending on how successful the enterprise is) – like treating return allowances with corporations –

are tied to the business or co-entrepreneur's share or real estate in question and cannot be transferred to other businesses and, therefore, are lost when the underlying source of income is disposed of (section 253).

4.5.3.2 Surplus Income and Surplus Accounting

350. Income accounted on a cash basis – income from employment, from rent and lease (not opting for accountancy) and business income for the purposes of § 4 para. 3 ITA – is assigned to the correct category of income from the start without being split. There is, therefore, no change from the law as it stands when it comes to setting off losses horizontally. Another point to note here is that, for the purposes of setting off losses with income from capital investment, there is no difference between dividend income biased with corporation tax and other capital gains. The only question is whether capital losses can only be set off against taxable capital gains (namely debt interest and dividends and capital gains exceeding the standard rate of return) or whether capital losses can also be set off against dividends and capital gains which remain within the standard rate of return and are, hence, exempt from tax. The only consistent approach is not to allow setting off such taxable and tax-exempt income components. This ensures that any capital losses can be assigned to setting off losses vertically at a later point.

4.5.4 Setting Off Losses Vertically

351. One essential feature of the version of dual income tax as proposed in this study is that it taxes capital income proportionally by extending the income tax schedule to include a proportional zone according to individual capital income (see section 277 pp. and § 32a para. 1 ITA draft). Bearing this in mind when calculating income, the income as determined in step one must be allocated to the various categories of income in full or pro rata depending on how it is defined (earnings or capital income) and taxed accordingly. This raises the question as to how this dual approach affects offsetting negative income between the different categories of income.

4.5.4.1 Intra-Schedular Set-Off

352. Tying losses to the category of income concerned would not be entirely alien to German tax law as has already been touched on above (section 342). Within the framework of a dual income tax, 'locking in' losses within a given category of income could even be elevated to a general rule. Any losses could then only be carried over from one period to another (after having applied the provisions for setting off losses horizontally). Treating losses so restrictively would presumably be out of line with German constitutional law requirements and would also be contrary to the principle of not distorting investment decisions (it would be 'worthwhile' to some extent only to invest within a certain category of income) and, therefore, is not advisable. Any attempt to justify deviations from the *objec-*

tive net principle – as a general measure to combat abusive tax planning, for example – seems highly doubtful but, above all, deferring setting off losses would not meet the economic demand for setting off promptly.

4.5.4.2 Setting Off Losses Indirectly via Tax Credits

353. There are better reasons in favour of making provision for setting off losses against income from all sources in the very same year when these losses arise. One approach discussed in the literature to enable capital losses to be set off (at least to some extent) is reducing the tax burden on earnings income by the product of the capital lost times the tax rate applicable to it.¹²² This ‘credit solution’ is particularly practised in the Scandinavian countries which structure income vertically.¹²³ It is especially attractive that it provides a certain symmetry between how profits and losses are treated, at least with income attributable to capital.

354. But this solution also raises constitutional law, systematic and practical concerns, mainly because such a ‘credit solution’ could result in a person having to pay tax even if their total income is zero or negative. That results in effects which have also been attacked in the debate on ‘minimum taxation’.

Example 34: A taxpayer yields 100,000 units in a year as earnings income but suffers a loss of capital of 100,000 units in that same period making his total income zero. Income tax liability (T 2005 excluding solidarity surcharge) on his earnings income amounts to 34,086 units, and his income tax due is reduced by 25,000 units on account of his capital losses leaving him income tax to pay of 9,086 (34,086 - 25,000) units. Even if he earns less than the subsistence minimum for tax purposes of 7,665 units, he still has to pay tax.

355. On the other hand, a merely indirect approach to setting off losses would be in contrast to the way we deal with losses with an income category where a profit split takes place (see section 345 pp.). But why, one might ask, should we treat losses on disposals of financial assets differently depending on whether those assets are held as part of a business or privately? It would be more in line with the rule of *consistency* to allow losses to be set off directly, irrespective of whether the different income sources involved come under the roof of business or not.

356. Finally, indirectly setting off losses makes it impossible to set off *negative earnings income* properly. The lack of a uniform tax rate makes it impossible to treat positive and negative earnings income accordingly. Nor can cases of negative earnings income be ignored if we remember that business losses are uniformly assigned to earnings income.

¹²² See German Council of Economic Experts (2003: section 596 pp.); Englisch (2005: 29 pp.).

¹²³ Norwegian law is different, in that it provides a mixed basis for assessment with ‘alminnelig inntekt’ [general income].

4.5.4.3 Setting Off Losses Directly

357. It would, therefore, appear preferable to allow ourselves to be guided for the purpose of setting off losses vertically by the existing method used in calculating ordinary profits (see section 345 pp. above), that is to say when determining the basis for tax assessment, to start from the net profits for an assessment period and apply the appropriate rate of tax. The asymmetry in how it is made up (such as losing capital income but making a profit on earnings income) could be matched between periods. This reduces the chances of using ‘return components’ in subsequent years.

358. When it comes to actually designing how losses are to be set off directly, this means we have to split the process into three stages. First, there is an intra-schedular netting of positive and negative income within each category of income concerned. The next step is to take any resulting negative earnings or capital income and deduct that from the assessment base for the year (known as ‘total income’ according to our ITA draft). If we deduct negative capital income from positive earnings income in any year, the third and final step is to increase earnings income’s ratio of total income exactly by the amount of the capital losses deducted previously, provided capital income is still positive (defined as *loss matching* in our proposal). There is, therefore, no clear advantage to be drawn from allowing capital losses to reduce earnings income taxed at a higher rate. The same mechanism also applies conversely, i.e. setting off negative earnings income against capital income. As with splitting profits from business income, it is only how total income is made up which changes, not the amount involved.

Setting off losses between periods in this way needs to be documented and adjusted the same way as netting losses between periods in § 10d ITA. Any negative capital or earnings income set off when calculating total income must be separately determined first. In the following year, any remaining loss matching unit must be determined: In each case their amount depends on whether and, if so, to what extent units carried forward have changed, how total income is made up and new loss matching units have arisen.

Example 35: Table 29 shows how setting off losses directly over a 3-year period works. When calculating the loss netting remaining at the end of the year, it must be remembered that the loss matching in each case (lines 9 and 13, respectively) is limited by the value of the total income. In Year 2, for example, the earnings loss of EUR 40,000 is made up for primarily by offsetting losses, not by reclassifying them as a result of loss matching. This explains how a capital loss still to be matched of EUR 40,000 remains at the end of Year 2. We have also opted to ignore the solidarity surcharge when calculating tax: that is to say, we used a proportional rate of 23.7% for capital income and the income tax schedule as documented in section 277 pp. for earnings income.

As the results show, the total income of EUR 260,000 is taxed as a whole as earnings income (or capital income), thus, setting losses off against capital income between periods does not offer any opportunity for tax planning. On the other

hand, loss matching ensures that the objective and subjective net principle are maintained and that the subsistence minimum is not taxed.

4.5.5 Setting Off Losses Between Periods (Deducting Losses)

359. Setting off losses between periods continues to work as it does under the system of setting off losses as proposed. There is one modification to remember: There has to be a split between negative, non-offset earnings and capital income to ensure identifying the loss matching units to be established via setting off losses vertically in the future. Losses that arise in any one assessment period and which have not already been set off within the category of income in question, are, therefore, allocated to two complementary inter-period setoff mechanisms which transcend individual assessment periods: Losses which are set off on an inter-schedular basis are reclassified via so-called loss matching; any losses that cannot be set off reduce future income via the well-known mechanism of deducting losses.

Table 29. How setting losses directly works (Loss matching)

	Year 1	Year 2	Year 3	Total for years 1-3
Calculating total income				
(1) Earnings income	200,000	-40,000	100,000	260,000
(2) Capital income	-100,000	100,000	0	0
(3) Total income [(1) + (2)]	100,000	60,000	100,000	260,000
Dividing income after balancing losses				
(4) Earnings income $\{\min[(1) + (14) / (t-1) - (10) / (t-1); 3]\}$	100,000	60,000	100,000	260,000
(5) Capital income $\{\min[(2) + (10) / (t-1) - (14) / (t-1); 3]\}$	0	0	0	0
(6) Total income	100,000	60,000	100,000	260,000
Remaining balancing losses				
<i>Balancing earnings losses</i>				
(7) Balancing losses carried over	0	0	40,000	.
(8) Earnings losses set off	0	40,000	0	.
(9) Earnings losses balanced	0	0	40,000	.
(10) Earnings losses to be balanced [(7) + (8) - (9)]	0	40,000	0	.
<i>Balancing capital losses</i>				
(11) Balancing losses carried over	0	100,000	40,000	.
(12) Capital losses set off	100,000	0	0	.
(13) Capital losses balanced	0	60,000	40,000	.
(14) Capital losses to be balanced [(11) + (12) - (13)]	100,000	40,000	0	.
(15) Tax	34,086	17,286	34,086	85,458

360. As will be clear from the preceding sections, dealing with losses properly under a dual income tax system is *more complex* to some extent: All the more so if losses can be deducted and matched not only into the future but also into the past.

Then the question arises in particular whether the existing option of carrying back losses (§ 10d para. 2 ITA) should continue to be offered. There can be no doubt, both from an economic standpoint and with an approach to ability to pay from a lifetime perspective, that the best solution would be to allow losses to be carried back and forward without limit. On the other hand, these considerations should also be seen in the overall context of how losses are set off at present. If reforming deducting losses, a system which combines deleting the existing limits with restricting how losses can be set off over time would appear as a balanced overall solution meeting fiscal and administrative requirements on the one hand and economic requirements on the other hand.

4.6 Dealing with Trade Tax, Assuming It Is Retained

361. Trade tax is one of the particular “bugbears” of the German business tax system as it currently stands. It puts an exceptional burden on business activities and, therefore, is a major disincentive when it comes to doing business in Germany. This opinion supports proposals that trade tax should be integrated with income and corporation tax. There could conceivably be a general surcharge (including municipalities’ entitlement to fix a multiplier) on corporation and income tax. Firstly, this would eliminate the irregular differences between the tax bases of income tax and trade tax (additions and reductions); secondly, it would convert the revenue base from a burden on business only to a burden on local citizens in general. The aim here is that the total tax on business income, including a local authority surcharge tax, should not exceed the rate of 25% or thereabouts. We must also avoid the risk of taxing dividends twice with both income and corporation tax. We can do this by taking dividend payments out of any additional local authority tax as far as shareholders are concerned in principle.

362. In the final instance, however, introducing dual income tax is not about whether the existing trade tax should be abolished. If trade tax cannot be integrated as a surcharge tax in income and corporation tax, on the other hand, the ambitious objectives that the concept of a dual income tax addresses when reforming business taxation can be achieved only to a limited extent. Capital income would not be uniformly taxed if trade tax is differently applied to profits and interest. Current breaches of finance neutrality are also based on trade tax, which applies to corporations’ profits in full but which largely spares profits earned by transparent entities through being roughly imputed against income tax (§ 35 ITA) and charges interests only partially.

363. If trade tax continues to be levied as it now stands, the only way of achieving any far-reaching neutrality with regard to legal form and company finance would be to *allow trade tax to be imputed against income and corporation tax*. *The maximum amount of imputation* is equal in principle to *income or corporation tax liability*. Imputation of trade tax could be simplified if trade tax was no

longer deductible as business expenditure and would also require fixing a maximum multiplier applied by the municipalities in order to limit the incentives to local authorities to increase their multiplier on account of the federal treasury or the treasuries of the federal states. One way might be to use the *average federal trade tax multiplier*, which was 432% for local authorities with populations of more than 50,000 in 2004.¹²⁴

364. As the trade tax burden depends on what multiplier local authorities actually apply, the proposed capital tax rate of 25% would be reached only if the actual municipal multiplier casually corresponds to the average federal local authority multiplier. This is the only way of achieving anything like legal form neutrality for the *marginal investment*. If the applied multiplier were any higher, this would upset the synchronicity for corporations of taxing the company and relieving shareholders by releasing the proportion of dividends to the amount of the return allowance. In the case of transparent entities, profits up to the standard rate of return would then be taxed at more than 25%.

365. With *debt financing of companies*, the tax on interest would, in principle, be equal to the corporation tax rate of 25% insofar as the trade tax on half of the interest expenses can be imputed by the debtor. On the other hand, imputation would not be available in years in which losses are made since not enough corporation tax would be due. Interest expenses of transparent entities that reduce their profits liable to trade tax are also subject to trade tax, as half of the interest is added back and the income tax bill falls short of the amount available for imputation. Thus, this does not provide the finance neutrality required any more than under current law.

366. Trade tax will also impact on tax on what transparent entities and corporations earn beyond the return on equity capital albeit trade tax is imputed. Even if corporations manage to have trade tax imputed in full, they still have to pay tax on profits distributed at 43.75%; but this tax is exceeded insofar as the corporation's profits are taxed at more than 25% on account of exceeding trade tax imputation. The trade tax burden on earnings by transparent entities exceeding the standard return on equity capital will amount to more than personal income tax even if profits are only slight due to imputation spill-over. The closer the average rate of tax comes to the top rate of income tax, on the other hand, the more unlikely imputation will be excessive with regard to trade tax multipliers currently applied. As a general rule, for incrementing trade tax multipliers the tax burden on profits by corporations exceeding the standard return on equity will be higher than that for transparent entities.

Example 36: Table 30 shows the top tax rate on additional earnings if trade tax is imputed against income or corporation tax at not more than the average federal multiplier of 432%. If it can be imputed, trade tax can no longer be de-

¹²⁴ See Institut Finanzen und Steuern (2004).

ductible as business expense: The trade tax rate is, therefore, obtained by multiplying the uniform federal rate of 5% by the specific municipal multiplier. The burdens at multiplier rates of 300%, 400%, 432% and 500% are given for comparison purposes.

367. If trade tax remains in its current form even if it can be imputed against income or corporation tax, this is still in breach of the dual income tax system's neutrality characteristics in respect of marginal investment. This also creates different burdens for different legal forms when it comes to taxing profits above the standard return on capital.

These distortions could, of course, be avoided by allowing trade tax to be imputed against income and corporation tax without limit but this is not a realistic option as local authorities cannot be allowed to increase their multiplier rates without limit to the detriment of conjoint taxes. One limited solution to the neutrality issue would be to carry imputation over spills forward to subsequent years, however.

Table 30. Tax burden effects at different trade tax levy rates

	Trade tax levy rate							
	300%		400%		432%		500%	
	Corps.	TEs	Corps.	TEs	Corps.	TEs	Corps.	TEs
(1) Additional earnings	100	100	100	100	100	100	100	100
(2) Trade tax	15	15	20	20	22	22	25	25
(3) Corporation tax								
(25% of (1) – min [(2); 21.60])	10	.	5	.	3	.	3	.
(4) Dividends [(1) – (2) – (3)]	75	.	75	.	75	.	72	.
(5) Income tax								
(5a) 25% of (4)	18.75	.	18.75	.	18.75	.	17.90	.
(5b) 44.31% of (1) – min [(2); 21.60]	.	29.31	.	24.31	.	22.71	.	22.71
(6) Net profit	56.25	55.69	56.25	55.69	56.25	55.69	53.70	52.29
(7) Tax burden (%)	43.75	44.31	43.75	44.31	43.75	44.31	46.30	47.71

368. Notwithstanding the imputation method, consideration could also be given to reduce the corporation tax rate and, therefore, the discrimination against self-financing; but as the corporation tax rate must be uniformly set for Germany while trade tax will still vary in future as a function of specific municipal multipliers, finance neutrality can only be achieved for a specific multiplier. Thus, there are no decisive gains compared with imputing trade tax as proposed here.

369. Unless trade tax is thoroughly reformed, ensuring neutrality of taxation in terms of legal form and financing business will be purely theoretical. This pessimistic conclusion applies not only to dual income tax but also to any other model on reforming business tax.

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List of Abbreviations

German Tax Laws

CTA	Corporate Tax Act
GTC	General Tax Code
ITA	Income Tax Act
RTA	Reorganisation Tax Act
TTA	Trade Tax Act
VTA	Valuation Tax Act

Other Abbreviations

AR	Annual Report of the German Council of Economic Experts
BGBI	Federal Law Gazette [<i>Bundesgesetzblatt</i>]
BFH	Federal Tax Court [<i>Bundesfinanzhof</i>]
BFHE	Federal Tax Court ruling
BGH	Federal Supreme Court [<i>Bundesgerichtshof</i>]
BGHZ	Federal Supreme Court judgments in civil matters
bn	Billion
BStBl	Federal Tax Gazette [<i>Bundessteuerblatt</i>]
BVerfG	Federal Constitutional Court [<i>Bundesverfassungsgericht</i>]
BVerfGE	Federal Constitutional Court judgments
DIT	Dual income tax
DStR	Deutsche Steuerrundschau [<i>German tax review</i>]
EC	Equity capital
EC Treaty	Treaty establishing the European Community
EU	European Union
EUR	Euro
GmbH	Limited liability company
GmbH & Co. KG	Limited partnership with a limited company as general partner
IFRS	International Financial Reporting Standards
KG	Limited partnership
m	Million
MPI	Max Planck Institute for Intellectual Property, Competition and Tax Law
SME	Small and medium sized enterprises
SVR	German Council of Economic Experts
T 2005	Income tax schedule 2005
VAT	Value added tax
ZEW	Centre for European Economic Research

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