



German corporate taxes

Growing need for action

September 14, 2018

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Original in German: September 6, 2018

Since the last corporate tax overhaul in 2008, the need for reform has been steadily building in Germany. High tax rates; relatively restrictive depreciation allowances; a lack of broad-based, systematic R&D tax incentives; and the increasing complexity of tax law weigh heavily on the investment climate. The federal government appears to have taken insufficient account of this.

Given the ongoing criticism of Germany's current account surpluses, a reduction in corporate taxes would be a strong signal to stimulate sluggish domestic investment activity, thus addressing a key issue of the current account discussion.

The international trend towards lower tax rates also needs to be addressed, if Germany is to retain its competitiveness as a site for investment, innovation and jobs. By 2020, taxes for corporate entities in major neighbouring countries will undercut Germany's 30% rate by up to 13 percentage points. Germany has lost ground vis-à-vis the US recently. Measures in the US included a reduction in the federal corporate tax rate from 35% to 21% and immediate expensing.

In the face of technological competition with the US and China in the areas of AI and robotics, Germany needs enhanced incentives to promote R&D activities, if it does not want to run the risk of falling (further) behind. The introduction of an income tax credit to the tune of 10% of R&D staff expenditure, as proposed by the BDI (Federation of German Industries), could provide such incentives without overstressing public coffers. When securing the attractiveness of Germany as an innovation site, patent box regimes could also play an important role.

As regards the implementation of international measures against unwanted tax base reductions and profit shifting of multinational companies (under the OECD BEPS Action Plan and resp. EU initiatives), Germany is among the frontrunners. But this is problematic if other countries fail to follow suit in a decisive fashion. International efforts to create a level playing field for the calculation of taxable earnings could then backfire – at the expense of German companies. Therefore, appropriate implementation of international and EU standards is fundamental.

Another noteworthy factor is that corporate income tax and the double taxation of equity capital (for the company and the (share)holders) has led to distortions in investment decisions and between equity funding and external financing. With allowance for corporate equity schemes (ACE), i.e. the adjustment of (taxable) equity capital corresponding to interest rate trends, academics have suggested remedies that have been taken up by the EU Commission.

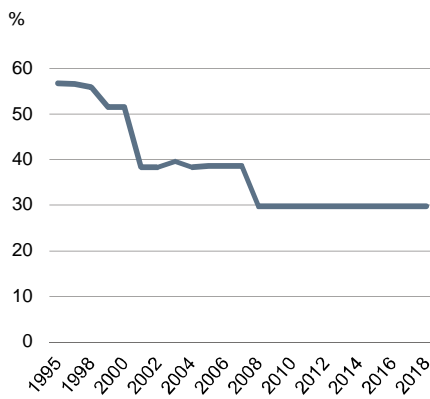
The necessary reforms must be addressed swiftly. The plans have been on the table for some time now. With state coffers filled to the brim, the short-term costs of the overhaul, i.e. tax shortfalls, should be manageable. In the medium to long term, a growth-oriented policy would help to boost income and employment, hence retaining sources of tax revenue.



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Corporate taxation takes a back seat

Average rate of corporate taxes in Germany



Sources: Federal Ministry of Finance, ZEW Mannheim

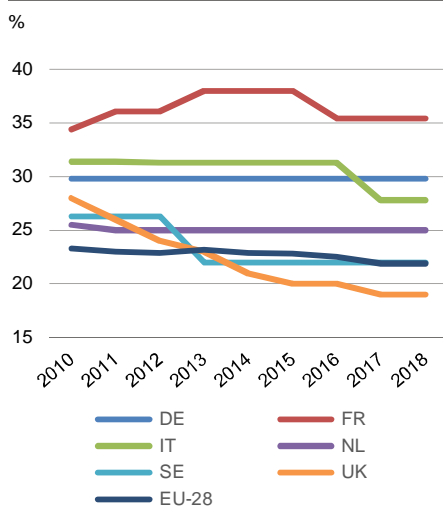
For years now, corporate taxes have been playing second fiddle in German politics, and there is little evidence that this is likely to change in the foreseeable future. In the coalition treaty, signed in March by the CDU/CSU and the SPD, international and European initiatives are taking a front seat. These are aimed at "fair" taxation of large international companies, including anti-tax avoidance measures, and at a common corporate tax base for Europe, which is also intended to facilitate cross-border activity and investment in the Single Market. Beyond the international and European level, however, the areas in which the Grand Coalition wants to set impulses of its own are limited; one example is promotion of research and development activities in small and medium-sized companies.

This piecemeal approach hardly seems appropriate. The last comprehensive German tax reform is now 10 years behind us. But, like the overall environment, the international landscape of corporate taxation is also subject to permanent change. On the agenda of pressing reforms in Germany, corporate taxation should be given top priority.

In the past decade, Germany's international competitive position initially improved visibly, courtesy of a reduction in the corporate tax rate from 25% to 15% (2008, nominal overall tax burden, including local business tax, down from 51.6% in 2000 to around 30%) and improved conditions for the retention of profits. But some shortcomings of Germany's corporate tax system persisted following the reform. Furthermore, new problems emerged, owing to the broader tax base, as, for instance, local business tax may no longer be offset against corporate tax. Meanwhile, the need for action has increased even further, as the international train of tax reforms and tax cuts keeps rolling.

In view of the ongoing criticism of Germany's current account surpluses, a reduction in corporate taxes would also be a strong signal to stimulate weak domestic investment activity, thus addressing a key issue of the current account discussion – weak business investment.

Top statutory tax rates on corporate income



Source: European Commission

Intensifying international tax competition must be addressed

Some EU countries have lowered corporate tax rates sharply in recent years, including Belgium (nominal tax rate down from 34% to 25% by 2020), Denmark (from 21% to 18%), France (from 33.33% to 25% by 2020), Italy (from 27.5% to 24%), Croatia (18%, previously 20%), Slovakia (21%, previously 22%) and the UK (from 20% to 17% by 2020). Thus, following Brexit, a major country with considerably lower tax rates will be a neighbour to the EU – and hence to Germany.

Given the extensive US tax reform, Germany has fallen further behind. Most of the US tax changes took effect at the beginning of the year, including a reduction in the federal corporate tax rate from 35% to 21% and increases in depreciation allowances. Furthermore, the foreign tax system was moved from the residence principle to the origin principle, which also applies in Germany and many EU countries.¹ In tandem with this systematic shift, the US administration introduced tax incentives (lower tax rate) for the repatriation of foreign-source

¹ As they were taxed in accordance with the residence principle before entry into force, profits of US companies were subject to the then relatively high tax rates in the United States, i.e. the country where the parent company resided. If repatriated, this also applied to the profits of their foreign subsidiaries (with credit for the taxes paid abroad). As a consequence, US companies had an incentive to leave their earnings abroad. In accordance with the origin principle, under which profits are taxed where they arise, foreign subsidiaries of US multinationals, in principle, now pay the tax rate of the country where they reside ("permanent establishment" criterion).

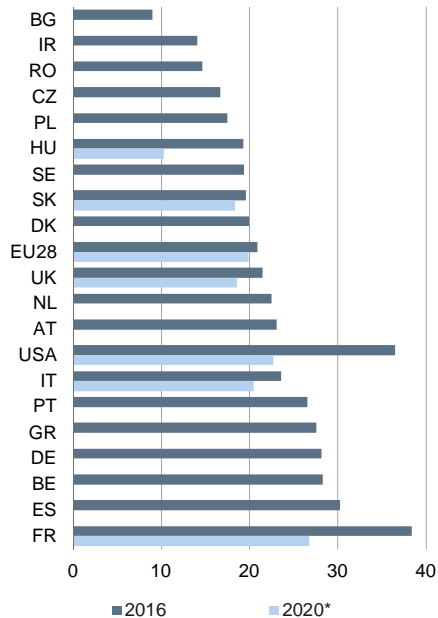


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Average effective corporate tax rates

3

%



* calculated on the basis of the tax reforms agreed or passed through end-2017

Source: ZEW Mannheim

profits, along with measures to discourage profit shifting to low-tax countries, such as the introduction of a licence barrier (see below).

Even though the tax burden is unlikely to have declined on an equal scale, above all due to (to date) largely unchanged regional tax rates (and the right of the federal states to set their own rules for computing the tax base), the US' position in international tax competition has improved substantially. According to model calculations (for hypothetical investment) of the Centre for European Economic Research (ZEW) in Mannheim, which reflect relevant changes in tax law, the effective tax rate dropped from 36.5% (in the State of California) to 23.3%, compared with 28.8% (2017) in Germany. At 20.9%, the average effective tax rate in the EU-28 is even lower than in the United States.

The EU CCCTB initiative – an ambitious future-oriented project

The changed tax policy landscape also encompasses initiatives of the EU and at the international level. The European Commission, for instance, plans to drive forward a comprehensive harmonisation of corporate taxation (with the exception of tax rates) across Europe. First tabled in 2011, the proposal for a common consolidated corporate tax base (CCCTB) aims to create a common single tax market with a one-stop shop. With the CCCTB, companies operating in several member states will have to comply with only a single EU rulebook for calculating their taxable income in one member state. Allowing taxpayers to offset profits in one member state against losses in another and distributing the tax base among the countries concerned (with permanent establishments), which requires appropriate criteria, the implementation of the one-stop principle is a challenging endeavour. Plans to introduce a comparable model for EU VAT were eventually dropped, given similar problems.

The Commission therefore plans to implement the CCCTB in a two-step process. Consolidation and the distribution of the tax base will be addressed at a later date. For now, the focus is on the creation of a common corporate tax base (CCTB). In October 2016, a corresponding proposal for a directive was presented.² Although the companies concerned would still have to cooperate with the tax authorities of the countries in which they operate permanent establishments, a common corporate tax base would alleviate administrative burdens and lower costs.

Another objective of the CCCTB and CCTB is "fair" taxation of corporate profits, to end or prevent profit shifting to countries with lower tax rates. Along with the CCCTB initiative, the Commission has therefore agreed on an "Anti Tax Avoidance Package", of which a key element, the Anti Tax Avoidance Directive (ATAD I), has already been adopted. A major objective of the package and the above-mentioned directive is the implementation of principles and rules stipulated in the OECD Base Erosion and Profit Shifting (BEPS) Action Plan. In line with the BEPS principles, corporate profits will be taxed in the country in which they are generated or where the economic activity takes place. But this is a broad and highly complex issue, which cannot be analysed in detail in this study.

With the proposal for a CCTB directive, some problematic elements of the ATAD I are exacerbated. For instance, both documents include interest limitation rules. Largely in line with the rules concerning limited deductibility of interest expenses introduced in Germany in 2008, both foresee a limit (of up to 30% of EBITDA), above which exceeding borrowing costs (i.e. costs in excess of interest or other revenues from financial assets) cannot be deducted. Unlike ATAD I and the German interest limitation rule, however, the directive features neither a carry-

² European Commission (2016). Proposal for a Council Directive on a Common Corporate Tax Base.



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forward clause (i.e. interest capacity that cannot be used may not be carried forward to later tax periods) nor an equity-related escape clause, which (if the ratio of equity to total assets is equal to or higher than the equivalent ratio of the group) allows full deduction of exceeding borrowing costs.

The German government supports the CCTB project. Together with France, it wants to push for quick adoption, as both parties pointed out in a short position paper issued in June. Both governments agree that the CCTB should be mandatory for all companies subject to corporate tax, not only those with consolidated global sales exceeding EUR 750 million, as suggested by the Commission. In addition, both demanded that the CCTB directive be more consistent with comparable ATAD provisions, including the abandonment of the planned modifications to the interest limitation rules.

It remains to be seen whether the proposal for a CCTB directive is indeed implemented in the foreseeable future – the more so as tax policy measures must be agreed unanimously in the EU. In January 2017 statement, the Dutch Senate noted that the Commission's proposal is incompatible with the principle of subsidiarity.³ As regards the situation in Germany, it is moreover noteworthy that a harmonisation of tax rates, which would limit intensifying tax competition from the CCTB, is not on the cards. In the end, addressing the challenges will be the responsibility of national policies.

Germany must leave its own mark—via lower tax rates, for example

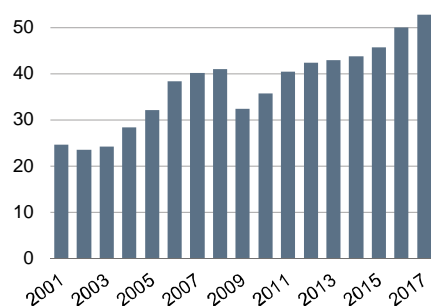
In view of the recent round of tax cuts in Europe and the United States, Germany cannot sit on the sidelines without jeopardising growth opportunities. Against this backdrop, not only industry associations such as the Federation of German Industries (BDI), but also renowned researchers, including the President of the Ifo Institute, Prof. Clemens Fuest, are calling upon the German government to take similar steps. This includes a 5 percentage point reduction in the corporate tax rate to 10%. With a nominal overall tax rate (corporate plus local business tax) of roughly 25%, Germany would then, at least, be back on a par with its neighbours Belgium and France.

Hardy local business tax

Experts – including Prof. Fuest – (alternatively) advocate eliminating the local business tax. It is well known that this tax has substantial shortcomings – particularly in its function as a municipal tax. Revenues largely depend on economic growth, even though the municipalities need a constant inflow of revenues. Economically sound cities, in particular, post high revenues, whereas "poor" municipalities hardly benefit from the tax. Furthermore, the local business tax adds to the system's complexity. Given provisions to add (25% of) deductible financial costs (in excess of the EUR 100,000 tax-exempt amount) back to taxable income, including interest on debt, rental, lease and royalty payments, not only does the local business tax itself become more complicated and disputable, but taxes may also be levied regardless of earnings. Finally, pass-through effects lead to problematic distributive implications. According to an analysis of the Ifo Institute, a larger share of the burden resulting from increases in local business tax is shifted to workers in the economically less dynamic regions (in east Germany). There, higher (municipal) multipliers (tax factors) come at the expense of (potential) wage increases.⁴

Growing receipts from local business tax

EUR bn



Source: Federal Statistical Office

³ European Parliament. Official Journal II 2016-2017, 34 604, No. 4, p. 11.

⁴ Fuest, Clemens, Andreas Peichl, and Sebastian Siegloch (2018). Do Higher Corporate Taxes Reduce Wages? Micro Evidence from Germany. *American Economic Review*, 108 (2): 393-418.



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Proposals to eliminate the local business tax and replace it with a local tax on net production value or by entitling municipalities to apply a multiplier to income tax (and corporate tax) have been on the table for many years. Alternatives which, due to international tax competition, would exclusively or primarily weigh on companies should be taken with a grain of salt, though. For its supporters, of course, the debate about local business tax always comes at the wrong time. For the municipalities, the tax is essential, whether state coffers are well-filled or empty. From 2010 to 2017, revenues were up by EUR 17.16 bn, i.e. nearly 50%, to EUR 52.87 bn. Accounting for 42% of their total tax revenues, local business tax is the main source of revenues for German municipalities. Unlike many researchers, representatives of the municipalities oppose a fundamental overhaul and, in particular, the elimination of the local business tax, and, alternatively, prefer strengthening the tax by means of a broader tax base, for instance via more comprehensive add-backs and the inclusion of the liberal professions. In the face of widespread opposition, plans of former Finance Minister Schäuble to do away with the tax failed in the past two legislative periods. Meanwhile, demands from industry representatives are focussed on the reduction of non-profit elements of local business tax and the resumption of former rules allowing the deduction from income and corporate taxes.⁵

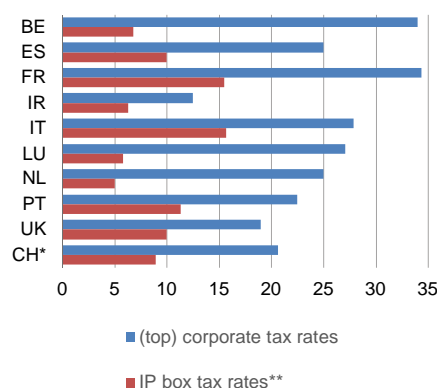
More systematic promotion of business R&D activities is required

One option to strengthen invention and innovation is the promotion of research and development, as is also well justified by the positive external effects of business R&D activities. So far, however, public promotion of R&D in Germany is project-related, with the wide umbrella of government programmes ranging from basic technologies to high-tech. Funds are provided by the federal government, the federal states, or jointly by both, and the EU. In addition, the federal government has launched special technology-neutral programmes for small and medium-sized companies (SMEs). Whilst the funding landscape is relatively broad-based, it is also complex and confusing. Generally, larger companies are the main beneficiaries – regardless of the special programmes for SMEs.

Tax rates for IP boxes or other IP preference regimes

5

2017 or most recent data available, %



* Canton of Nidwalden, ** percentage of revenues

Sources: Federal Ministry of Finance, IW Köln

Comprehensive, less bureaucratic promotion of R&D is required, the more so as funding of innovation is a key element of active location policy in many countries. Both input and output can be addressed. The former is the traditional method. In this case, the government supports the use of resources in the area of R&D by granting special depreciation allowances and/or direct subsidies or tax refunds, etc. The recent US reform package, for example, includes a 20% tax credit on R&D investment.

The second approach is based on so-called patent boxes (or licence boxes, or intellectual property (IP) boxes), which play an increasingly greater role in international competition for high-value-added mobile business activities. Patent boxes grant preferential tax treatment to revenues from R&D activities, namely intangible assets such as licences and patents, hence focusing on successful R&D projects. In the EU-28, these regimes exist in 15 countries, compared with just two states ten years ago. According to the ZEW, corporate income from intangible assets in (14 of) these countries is taxed at a reduced rate of around 7.9%, whereas the average income tax rate comes to 22.9%.⁶

⁵ BDI Federation of German Industries (2018). Steuerpolitische Prioritäten 2018-2021. Vorschläge zur Weiterentwicklung des deutschen Steuerrechts angesichts des internationalen Steuerwettbewerbs.

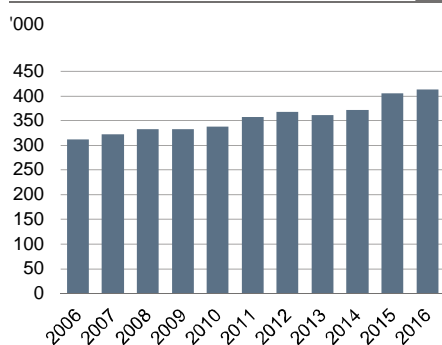
⁶ Stiftung Familienunternehmen (ed.) (2018). International tax competition – Evaluation, Trends and Conclusions for Fiscal Policy Makers. Study compiled by the Centre for European Economic Research (ZEW), Mannheim.



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German businesses' R&D staff

6



Sources: Federal Statistical Office, Stifterverband
Wissenschaftsstatistik

In the face of technological competition with the US and China in the areas of AI and robotics, Germany needs enhanced incentives to support R&D activities across all companies, if it does not want to run the risk of falling (further) behind. So far, the debate focuses almost exclusively on input-oriented promotion. Of the proposals from research, policy⁷ and industry, which cannot be discussed (in detail) in this study⁸, the introduction of a tax credit on R&D staff expenses has attracted particular attention. In line with academic analyses, the BDI favours a model which features a funding rate of 10% and allows companies to offset the credit (which does not count as taxable income) against payroll taxes. Helping them to shoulder R&D expenses, a major benefit of such a tax credit is its direct positive effect on the liquidity of the companies concerned. The fiscal costs of this funding scheme would be limited. Based on the assumption that, as mentioned above, the funding rate is 10%, the BDI expects losses in tax revenue to amount to around EUR 3.7 billion p.a. If funded expenses were limited to a salary (share) of EUR 60,000, revenue losses would come to EUR 2.5 bn (or 0.3% of overall tax revenues in 2017). As regards the scope and timing of additional R&D promotion, the German government is vague. In its coalition treaty of March, it merely notes that "we will improve conditions for innovation: R&D tax incentives, especially for the research activities of small and medium-sized companies".

Patent boxes under discussion

Another idea that is occasionally put forward is the introduction of patent boxes in Germany. In recent years, however, patent boxes and similar preferential regimes for intellectual property have triggered an international debate about how national tax sources can be secured. If taxes, in particular on income from intellectual property, are low in a specific country, this may provide an incentive for multinational enterprises to relocate these rights or revenues to that country. In practice, this may – in simplified terms – occur if a multinational establishes a (subsidiary) company in a country with IP boxes to manage and exploit licence and/or patent rights, and then collect high royalties from other subsidiaries that are located in higher-tax countries. According to empirical evidence, patent boxes (which were introduced before 2015) have all attracted patents that had high earnings potential.⁹ With the introduction of its own regime, Germany could buck the trend.

Over the past years, however, IP boxes have been on the radar of international initiatives against tax avoidance and profit shifting. Under Action 5 of the BEPS Action Plan (Countering "Harmful" Tax Practices), the international community has defined minimum standards for patent boxes to ensure that tax deductibility of costs incurred for the protection of intellectual property, such as licence fees, is aligned with adequate taxation of income and that taxation takes place in the country where "substantial activity" is undertaken. In addition, there shall be an adequate relationship between the preferential treatment of IP income and the related expenditures on R&D, for instance, and income shall qualify for tax benefits only in the country where the related expenditures were incurred (Modified Nexus Approach). Under this approach, licence income will not qualify

⁷ In its Proposal for a CCTB Directive, the EU Commission, for instance, suggests that, in addition to the costs which are fully deductible as R&D costs, an extra 50% of these costs (up to EUR 20m and 25% of the exceeding amount) may be deducted from the tax base. For many companies this would be a relatively generous funding scheme, but only profitable companies would benefit. In the EU comparison, the advantages would be most pronounced in the countries with the highest tax rates. The German and the French governments have already expressed their opposition to such incentive regimes in a CCTB directive.

⁸ See also Spengel, Christoph et al. (ZEW, Mannheim, 2017). Steuerliche FuE-Förderung. Study commissioned by the Commission of Experts for Research and Innovation. Studies on the German Innovation System No. 15-2017.

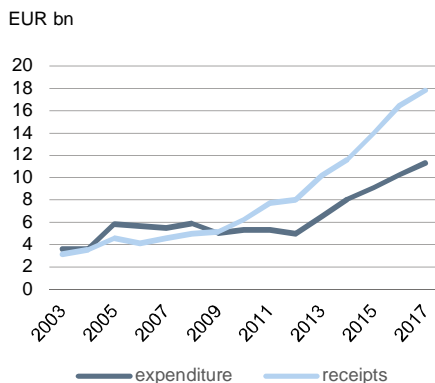
⁹ Tobias Böhm et al. (2015). Corporate Taxes and Strategic Patent Location within Multinational Firms. CESifo Area Conferences.



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German trade with patents, licences and other IP

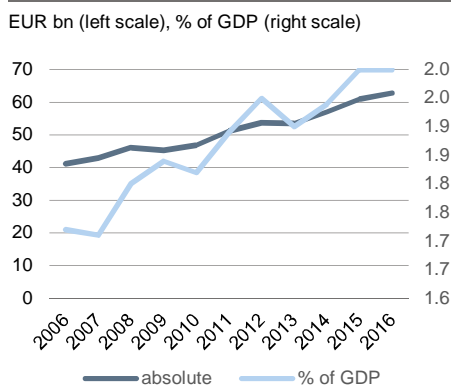
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Source: Deutsche Bundesbank

German businesses' R&D spending

8



Sources: Federal Statistical Office, Stifterverband Wissenschaftsstatistik

for preferential treatment in countries where no qualifying R&D activities were carried out. Likewise, revenues from non-technical industrial property rights such as trademarks are not entitled to tax privileges.

Though these standards limit the countries' leeway as regards the (legal) design of patent boxes and similar preferential regimes, they also counter the tendency to relocate R&D activities, including shifting for the primary sake of tax planning. Unless patent boxes in other countries are (re)designed in compliance with the new rules, this goal will not be achieved, though. This is particularly doubtful as regards non-eurozone third parties, given that the OECD rules are only politically binding, which means that violations cannot really be sanctioned.¹⁰

To thwart removal to IP boxes which do not conform to the rules, Germany adopted a "licence barrier" at the beginning of the year.¹¹ Since then, intra-group expenses incurred in connection with the right to use intellectual property cannot, or can only partially, be deducted, if the resulting income of the recipient is not taxed at all or only at a low rate courtesy of a "harmful" IP box (which does not comply with the Modified Nexus Approach).

As it may be an incentive for research-intensive multinationals to refrain from removing their R&D activities and the resulting patents and licences from the German investment site, it might be worthwhile for Germany to introduce such an instrument. But as an instrument for the general promotion of R&D activities, its positive effect is rather limited, particularly with respect to activities that carry a higher risk of failure or, for other reasons, are unlikely to mature into a profitable patent. Against this backdrop, patent boxes are a useful instrument only if input-oriented R&D promotion is enhanced simultaneously.

Proper implementation of international standards is essential

In Germany, provisions of higher levels are generally implemented in a timely fashion or even ahead of schedule. One example is the German licence barrier. But unilateral offensives of national lawmakers may lead to distortions at the expense of domestic companies. Moreover, the German rule undermines entrepreneurial freedom with regard to the deduction of operating expenses incurred by the German licensee, whereas the OECD rules are targeted towards states which have been urged to use only preferential regimes that are compatible with the rules.

It is generally problematic if individual countries are ahead of schedule when implementing international provisions. Risks are that the companies in the countries concerned will then have to operate in a considerably more restrictive tax environment than their competitors abroad. Germany is one of the states where progress in the implementation of the OECD's BEPS Action Plan or the EU Anti-Tax Avoidance Package tends to be swift and rather restrictive. Insofar as other countries are well behind schedule and/or hesitant to follow suit in a decisive fashion, international efforts to establish a level playing field for the calculation of taxable income may backfire, including risks of double taxation of multinationals, as expenditures incurred abroad cannot be deducted adequately in either the country where they arise or at home.

¹⁰ Within the EU, the situation is complex. Set up by ECOFIN in 1998, the Code of Conduct Group (Business Taxation), on principle, assesses the compatibility of IP boxes in the partner countries with regard to the Modified Nexus Approach pursuant to OECD BEPS Action Plan. Moreover, EU competition law issues are affected (unjustified state aid).

¹¹ The recent US tax reform also includes provisions (Base Erosion and Anti Abuse Tax, BEAT) to limit the deductibility of royalties paid by US (subsidiary) companies of foreign multinationals.



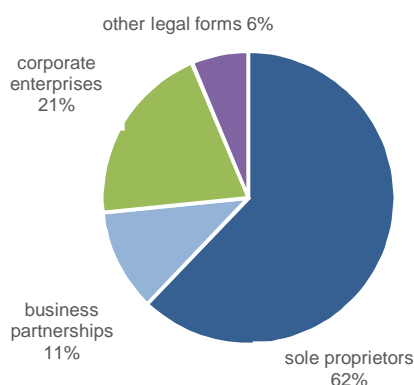
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"Controlled foreign corporation" taxation pursuant to the Foreign Tax Act is particularly restrictive in Germany. The aim of CFC rules is to ensure that a certain portion of the income of foreign companies that are controlled by a domestic entity is adequately taxed. Pursuant to the rules, revenues that are considered "income from passive activities" and are, in addition, subject to a low foreign tax rate, will be attributed to the domestic shareholders. When defining the qualifying income, the lawmakers apply the exclusion principle, specifying all harmless (active) income in § 8 of the Foreign Tax Act. But this catalogue is outdated and needs to be reformed. The same is true for the definition of low tax rates, which, in principle, are much too high, at a level of less than 25%. As a result, controlled foreign corporation taxation puts business investment of German subsidiaries in other countries at a disadvantage. Given that the German government has committed itself to an up-to-date redesign of controlled foreign corporation taxation, one can only hope that the problem will be tackled in the near future.

German enterprises by legal structure

9

Percentage share in all 3.476 m enterprises, 2016



Sources: Federal Statistical Office, Deutsche Bank Research

Corporate tax entails problematic distortions

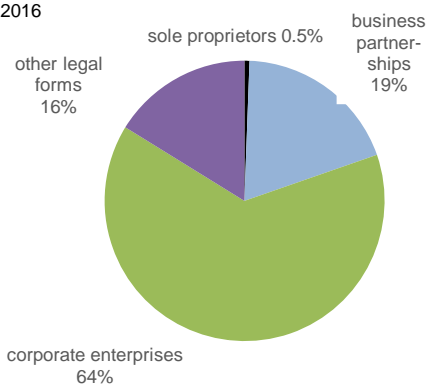
Apart from the current challenges, corporate taxation in Germany is also struggling with multi-year structural problems. Under the German tax system, business (investment) decisions are distorted in three respects. Firstly, debt is favoured over equity as a means of funding. Secondly, the existing (deduction) rules for the calculation of taxable income, can affect the ranking of profitable investment projects (of the same company). Thirdly, the system is not neutral with regard to the company's legal structure, but tends to favour corporations (2016: around 706,000) over partnerships (around 392,000).

Some of these distortions have considerable add-on effects, particularly as regards the lack of financial neutrality. Whilst interest payments on borrowed capital may (within limits) be deducted from corporate profits and are (so far) only subject to a flat-rate withholding tax to be paid by the recipients of that interest¹², equity finance capital is, as a matter of principle, taxed twice. On the one hand, the company has to pay corporate taxes. On the other hand, dividends distributed to shareholders, provided they are natural persons, are subject to a 25% withholding tax plus solidarity surcharge.¹³

Larger enterprises* by legal structure

10

percentage share in all 14,630 enterprises, 2016



* only companies with more than 250 employees

Sources: Federal Statistical Office, Deutsche Bank Research

Given their dependence on proprietary capital, the higher burden on equity finance above all weighs on young, fast-growing companies. The German Council of Economic Experts has repeatedly criticised this situation, arguing that German growth prospects are weakened, as a consequence. Although these distortions are substantially alleviated due to the multi-year low interest rate environment, they would quickly move back to the front burner if rates pick up.

As a general rule, a traditional (corporate) tax system that captures reductions in the value of assets over time and/or of their use, by means of depreciation based on acquisition costs when calculating the tax base, violates the postulate of investment neutrality. Thus, investment that – before or in the absence of taxes – would have been deemed uneconomical relative to alternative investment of capital funds, may make sense (and vice versa) when taxation is taken into account. This so-called profit tax paradox occurs as the present value of return flows (after taxation), which is relevant for investment decision-making, is affected by the path of return flows generated under traditional depreciation rules.

¹² According to the coalition treaty, the German government plans to scrap the flat-rate withholding tax on interest income, in favour of the former rule under which interest was taxed at the personal tax rate of the recipient.

¹³ This, however, exclusively applies to domestic shareholders. Foreign shareholders are exempted from domestic dividend taxes.



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If the straight-line method is applied, early return flows tend to increase the tax burden, whereas later flows tend to lower it.¹⁴

Partnerships are faced with the problem that (taxable) income of around EUR 54,500 p.a. (2018) already falls into the top income tax bracket of 42% (plus solidarity surcharge). Income exceeding around EUR 260,500 is taxed at a rate of 45% (plus surcharge). Upon application, retained earnings generated by a partnership are taxable at a reduced rate (28.25% plus solidarity surcharge). But if these profits are later withdrawn, the amount is subject to an additional tax of 25% (plus solidarity surcharge). Moreover, the regime is complex. Similar to corporate tax, the income tax scale has not been sufficiently adapted to actual needs for much too long. As a consequence, many owners of small enterprises fall into the top tax bracket. This is particularly problematic, as the effects of "cold progression", which occurs when income increases only reflect inflation but push taxpayers into a higher tax band, have not been corrected in recent years.

ACE and AGI allowance: Widely debated proposal with limited realisation prospects

Among researchers, different approaches on how to remove these distortions are being discussed, which – partly due to some major implementation problems – are only partially reflected in practice. One proposal that attracted broad attention was the allowance for corporate equity. To realise neutrality between debt and equity finance and (in the longer run) investment neutrality, companies would be allowed to deduct the (opportunity) costs of equity, equal to interest income from alternative investment in fixed-income securities, from their tax base.¹⁵ (The technical term for these systems is "allowance for corporate equity", ACE.) As the introduction of such a system would imply a strong reduction in tax revenues, it is primarily discussed in the (not fully neutrality-compatible) specific form of these deductions, only if equity is increased (AGI, allowance for growth and investment).

The German Council of Economic Experts supports this idea on a long-term view. Most notably, however, the EU Commission's proposal for a CCTB directive includes such a measure. Accordingly, taxpayers would be given an "allowance for growth and investment" (AGI), according to which "increases in their equity will be deductible from their taxable base subject to certain conditions". If equity decreases, a respective amount shall become taxable. The latter is problematic as losses may then be subject to additional fiscal penalties. The deductible amount is equal to the notional or defined (normal) yield and shall be calculated on the basis of the euro area ten-year government benchmark bond, or a minimum rate of 2% p.a. As a result, only income in excess of the notional normal yield on (increased) equity would be taxed. If, however, the allowance for corporate equity is limited to corporations, new distortions are likely to emerge. Solutions must be proposed for partnerships.

ACE/AGI systems already exist in several EU countries, including Belgium, Liechtenstein (both ACE) and Italy (AGI). In other countries such as Croatia (ACE, 1994 to 2000) and Austria (AGI, 2000 to 2004), these systems were introduced temporarily.

Studies on the experiences of the above countries show that systems using allowances for corporate equity or growth and investment (ACE and AGI, respectively) have positive effects on the capitalisation of companies as well as

¹⁴ Sigloch, Jochen (2009). Ertragssteuerparadoxa – Ursachen und Erklärungsansätze. Working Group Quantitative Tax Research (arqus), Discussion Paper No. 79.

¹⁵ Full investment neutrality would only be accomplished, if taxes on all types of interest income were scrapped when the allowance is introduced.

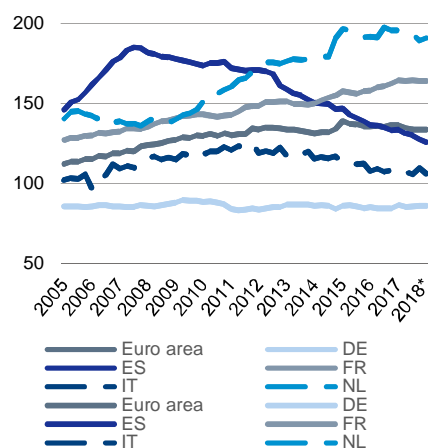


German corporate taxes: Growing need for action

Non-financial enterprises debt

11

Quarterly data, % of GDP



* Q1

Sources: Eurostat, Deutsche Bank Research

the macro economy. In Italy, leverage of the companies that used the domestic ACE system after its introduction was down by 9 percentage points, with SMEs posting an above-average decline.¹⁶ In Austria, equity ratios increased, whilst in parallel, profit distribution ratios of the companies under review declined. Both effects were more notable in companies that are part of a multinational group than in stand-alone firms.¹⁷

But the empirical studies also provide evidence that tax revenues decrease sharply when the tax base is narrowed by ACE systems, in particular. Moves to secure tax revenues by means of higher tax rates, however, undermine the positive welfare effects and may even reverse them. Above all, this holds if such systems, in combination with higher tax rates, are unilaterally introduced in individual countries. From this point of view, the EU Commission's proposal makes sense: that the EU countries should (unitarily) introduce the less revenue-harmful AGI regime in a more or less joint process.¹⁸ In the face of international competition, room for higher tax rates is, in principle, non-existent, though. Irrespective of this fact, both the German and the French governments rejected the Commission's AGI proposal in their position paper on the CCTB.

Immediate expensing of investments – an interesting element of US tax reform

Another (alternative) method to reduce distortions in investment decisions is immediate expensing of expenditures on these investments.¹⁹ Courtesy of the recent US tax reform, this feature is back in the spotlight. Since the end of September 2017, companies in the US are allowed to immediately expense the full value of certain capital investments, with the major exception of buildings, in the year they are acquired or put into service (prior to the reform, a 50% bonus depreciation was granted on these investments in the first year). This provision will fully apply for five years, followed by a phase-out period until 2026.

The German tax system only allows immediate deduction of minor assets in the amount of EUR 800 since the start of the year, up from EUR 410 previously. As regards other capital assets, the value can be depreciated either evenly over their useful life (straight-line depreciation) or depending on their use (activity depreciation). Prior to the 2008 tax reform companies could also apply the reducing balance method, which allows particularly high depreciation in the first year and thus comes closest to immediate expensing. (Back then continuous deductions of up to 30% were allowed.)

¹⁶ Brazoli, Nicola and Antonella Caiumi (2018). How effective is an incremental ACE in addressing the debt bias? Evidence from corporate tax returns. European Commission Taxation Papers. Working Paper No. 72.

¹⁷ S. Petutschnig, Matthias and Silke Runger (2017). The Effects of a Tax Allowance for Growth and Investment – Empirical Evidence from a Firm-Level Analysis. Working Group Quantitative Tax Research (arqus), Discussion Paper No. 221 and literature cited therein.

¹⁸ Another argument raised by its critics is that the Commission's proposal interferes with the member states' tax sovereignty, especially given its implications for income taxation. The Advisory Board to the Federal Ministry of Finance (2017). Finanzierungsneutrale Unternehmensbesteuerung in der Europaischen Union? Opinion on the EU Commission's Proposal for a Directive of October 2016.

¹⁹ Due to immediate expensing, the cost of the investment that is incurred by the company declines subject to its tax rate, whereas (non-reinvested) income (as the difference of the associated revenues and expenditures) decreases in all following periods subject to the tax rate. If the rate is unchanged over time, the net present values (present value minus initial outlay) of different or alternative investments before and after taxes only differ insofar as they were subject to different tax rates. Taxation is therefore investment-neutral, i.e. the ranking of an investment that had high earnings potential before taxes is not altered after taxes. But this – similar to ACE/AGI allowances – only holds if taxation of financial investment (interest income) is waived upon the introduction of immediate expensing. However, in providing an opportunity to shift funds from the real economy to the financial system to avoid taxes, this measure causes new distortions.



German corporate taxes: Growing need for action

But transition towards a comprehensive immediate expensing scheme is fraught with even greater problems than moving to ACE/AGI allowances. On the one hand, tax revenues are likely to decline substantially in the year the scheme is introduced.²⁰ How sharply they decrease also depends on how the existing capital stock is treated for tax purposes. One option – to be discarded on fiscal grounds – would be immediate expensing of the stock's book value. Alternatives, in particular the continuation of existing deduction modalities, would, to a greater or lesser extent, result in distortions.

In view of the above, calls for a tax system that includes an allowance for corporate equity or comprehensive immediate expensing of investment expenditures are fairly unrealistic in terms of German fiscal policy, at least for the time being, though other countries have taken steps in this direction.

Conclusion

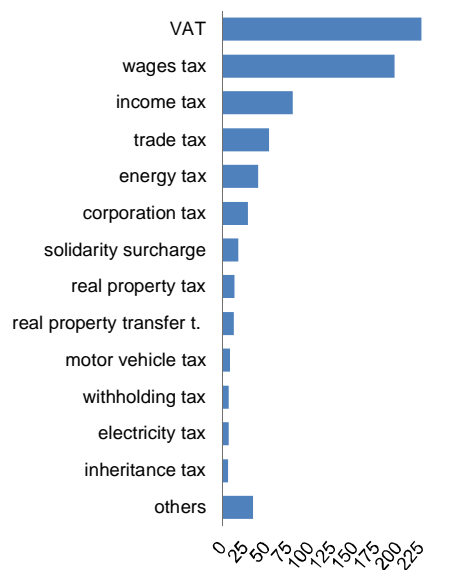
Given intensifying international tax competition, several guidelines and impulses from the European and international level as well as structural shortcomings in the (national) set of rules, corporate taxation in Germany faces many challenges. On top of that, taxing the digital economy is a complex issue, which needs to be analysed separately. Against this backdrop, some critics call into question a separate corporate tax regime besides the income tax. But this debate is rather academic. That policymakers will do away with corporate and local business taxes is an unlikely scenario – not least because of revenues of EUR 29.26 bn (30.87 bn incl. solidarity surcharge) and EUR 52.87 bn, respectively, in 2017. As such a decisive move would probably add fuel to the dispute surrounding income redistribution, and calls for a wealth tax and/or higher taxation of inheritances might grow louder. Thus, for Germany as an investment site, little would be gained.

But there are no obstacles in the way of the necessary corrections, in particular a reduction in tax rates – to 25%, at least, as in France, improved depreciation allowances, enhanced R&D incentives for all companies, adjustments in the Foreign Tax Act and decisive moves to offset the "cold progression" in income tax. These reforms are pressing. Given major changes in the international landscape of corporate taxation and nearly a standstill at home for ten years, Germany may fall behind in the international competition to attract investment, as work has continued in many other countries. Although the German government is playing the European card, it rejects interesting elements of the CCTB proposal. Given the diverging interests of the member states, there is also a great risk that the reform does not come in a timely fashion, if it reaches Germany via Brussels. To secure its attractiveness as a site for investment and innovation, Germany itself must move quickly and undertake the necessary reforms. Plans that go in the right direction are already on the table. With state coffers filled to the brim, the short-term cost of the overhaul, i.e. a reduction in tax revenues, should be manageable. In the medium to long term, growth-oriented policy will help to boost income and employment, hence retaining major sources of tax revenue.

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Government receipts from selected taxes in Germany

2017, EUR bn



Source: Federal Ministry of Finance

²⁰ In the United States, the Joint Committee on Taxation expects total tax shortfalls in the period from 2010 to 2022 to amount to USD 119 bn. Additional immediate expensing of certain investments of small enterprises is expected to result in further tax losses of USD 21 bn. In sum, this is equivalent to roughly one-fourth of the total effect of the US reform in the same period. Including the phase-out period, in which tax revenues will be higher, shortfalls will come to USD 86 bn.



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Printed by: HST Offsetdruck Schadt & Tetzlaff GbR, Dieburg

ISSN (Print): 2511-8552