

German Business Taxation – Business Start-up

Abstracts

“As the gardener plucks each flower in the garden, without destroying the roots, so should the ruler collect revenue without destroying the sources.” –Kautilya¹

The above Maxim from the Book “Maxims of Chanakya” which interpreted the Duties and Qualities of the Ruler. The above maxim “Shlok” of Kautilya emphasizing the need for wealth creation and underlines the principle of equity in taxation which requires today globalize world to maintain appropriate tax administration at International tax space.

The above-mentioned principle stated that Government should work as guardian to business entity while framing the Tax policies which help to grow business activity during the initial phase of start-up. The government carefully frame below mentioned tax policies and tax reforms not only to protect the business interest in local market but help to compete international space.

- Corporate Tax planning
- Tax incentive scheme
- Thin capitalisation Rule
- Avail benefit under Double taxation Avoidance Agreement (DTAA) while enter with double taxation agreement with other tax jurisdiction
- EXIM Policies

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¹ <https://www.scribd.com/document/366816436/Maxims-of-Chanakya-V-K-Subramanian>

1] The concept of tax planning for start-up business

Cutting income taxes on profits from entrepreneurial or innovative behavior will certainly produce an increase in entrepreneurship and innovation at private business firms—right? It seems at first straight forward: Providing income tax incentives will increase the after-tax profits of the entrepreneur and therefore increase the motivation to engage in entrepreneurial or innovative activity. But this standard analysis does not apply for start-ups and other capital-constrained firms that face a low probability of success.²

Instead, as we show in this Article, capital-constrained start-ups will only use conventional income tax breaks in the unlikely event that they succeed and become profitable. Meanwhile, sums invested in planning to reduce income taxes are not available for core business spending. Therefore, a start-up considering income tax planning must balance, on one hand, the advantage of a reduction in tax due on any future profit against, on the other hand, the disadvantage of reducing business spending, which, as a result of the capital constraint, reduces the firm's expected probability of success.

Our argument that income tax breaks for entrepreneurship or innovation should not be expected to motivate the desired behavior at new start-up firms contrasts with frequent and broad recommendations for the adoption of such tax breaks. Daring and ambitious start-up businesses, of the sort that have fueled venture capital ("VC") profits and built Silicon Valley's brand, are more likely to embrace new or risky projects with possibly enormous payoffs of global scope. This probably means that start-ups are more likely to embrace innovation. Policymakers may wish to encourage such innovation by start-ups even more. But income tax incentives that require planning investment and that are directed at the early stages of a start-up's life are unlikely to successfully increase innovation and entrepreneurship.³

Our argument is also in tension with recent arguments that income tax breaks are sometimes superior to patent protection and other approaches to encouraging innovation. One attractive feature of income tax breaks is said to be their capacity to subsidize an innovative project earlier in time. Another perceived advantage is that income tax breaks provide benefits even if the project fails. It is said that these advantages are not available for leading alternative innovation-boosting policies, such as patent protection. But they are also not associated with income tax-reducing policies undertaken by new start-up firms. Start-up firms are generally not profitable for years after their founding. Also, income tax assets often cannot be transferred. Thus, such benefits are often only valuable to a start-up if the firm itself becomes successful.⁴

² See generally E. Cary Brown, Tax Incentives for Investment, 52 Am. Econ. Rev. 335, 338 (1962) (explaining that "one can cut the rate of income tax to equalize the effect of [an] interest rate cut" and similarly affect the calculation of the net present value of an investment).

³ Such ambitious start-ups do not make up the largest proportion of new or small businesses. See, e.g., Eric Hurst & Benjamin Wild Pugsley, What Do Small Businesses Do?, Brookings Papers on Econ. Activity, Fall 2011, at 73 (presenting data that show that most small businesses are small and often local service businesses with "little desire to grow big or to innovate in any observable way").

⁴ See, e.g., Alvin C. Warren, Jr. & Alan J. Auerbach, Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing, 95 Harv. L. Rev. 1752, 1758-59 (1982) (explaining that depreciation deductions cannot provide the same

2] German Income Tax structure (Corporate Tax & Trade Tax)

Germany is a democratic and social federal republic consisting of 16 states (Länder), each with its own constitution, government and independent court. The federal president is the formal head of the state. The head of the federal government is the federal chancellor, who is elected by a majority vote of the lower house of parliament (Bundestag). The federal parliament is responsible for major legislation on economic policy and other matters. It comprises the directly elected Bundestag and an upper house (Bundesrat) formed by delegates of the Länder governments.⁵

Germany ranks 16th on the Tax Foundation's 2019 International Tax Competitiveness Index, a study that measures and compares how well OECD countries promote sustainable economic growth and investment through competitive and neutral tax systems. With Germany having seen few major changes to its tax system over the last years, this ranking has been relatively stable.

Looking at the different areas of taxation, Germany ranks above average on consumption taxes and international tax rules, average on property taxes, and relatively low on corporate and individual income taxes.

Germany's Ranking on the 2019 International Tax Competitiveness Index

Category	Score (out of 100)	Ranking (out of 36)
Overall	66.94	16
Corporate Income Tax	52.35	26
Individual Taxes	60.41	26
Consumption Taxes	75.93	10
Property Taxes	65.81	16
International Tax System	87.23	8
Source: Tax Foundation, "2019 International Tax Competitiveness Index." ⁶		

Reforms for 2020 include a new research and development (R&D) tax credit, the abolishment of the solidarity surcharge for most income groups, various changes in taxing energy use, and an overhaul of property tax valuation.

benefit to an unprofitable start-up company as they do to a profitable company); Myron S. Scholes, Mark A. Wolfson, Merle Erickson, Michelle Hanlon, Edward L. Maydew & Terry Shevlin, *Taxes and Business Strategy* 126-27 (5th ed. 2015) (illustrating how the progressivity of the tax rate schedule disadvantages start-ups with net operating losses).

⁵ <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-germanyguide-2017.pdf>

⁶ <https://taxfoundation.org/publications/international-tax-competitiveness-index/>

Most important forms of doing business

- Stock corporation (AG)
- Limited company (GmbH)
- Limited partnership with a limited company as general partner (GmbH & Co. KG)
- Limited partnership (KG)
- General partnership (OHG)
- Societas Europae (SE)

Legal entity capital requirements

- AG: EUR 50,000
- GmbH: EUR 25,000
- SE: EUR 120,000

Residence and tax system

A corporate entity is resident in Germany for tax purposes if either its place of incorporation (registered seat) or its place of central management is in Germany. Resident companies are taxed on their worldwide income. Non-residents are taxed only on their German source income, as defined in German tax law.

Corporate Income Tax & Trade Tax

Germany levies the third highest combined corporate income tax rate at 29.8 percent among European OECD countries (France and Portugal have higher rates at 34.4 percent and 31.5 percent, respectively), and the fifth highest among all OECD countries. The German Economy Minister proposed to cap the combined rate at 25 percent amid lowered expected GDP growth, but the proposal did not find its way into the 2020 budget.

Germany did, however, decide on a new R&D tax credit. Starting in 2020, businesses can claim a tax credit worth 25 percent of the wages and salaries paid to research staff. The base is capped at €2 million (US \$2.3 million), translating to a maximum tax credit of €500,000 (\$565,000). While R&D credits can foster innovation through R&D activity, technology transfer, and entrepreneurship, they tend to benefit certain firms and industries more than others, creating distortions in the economy.

The corporate tax rate is 15%, plus a 5.5% solidarity surcharge which is partially abolished, which results in a combined rate of 15.825%. Trade tax, typically at rates between 14% and 19%, also is imposed (see 3.4 below).

Resident corporations are taxed on their worldwide income. However, tax treaties may exclude foreign-source income from German taxation. Non-resident companies are taxed on certain German-source income, such as income from a German permanent establishment.

i) Taxable income defined

⁷All income of a corporation generally is considered business income. There is no distinction between capital gains and ordinary income.

Taxable income of a corporation is computed on the basis of the annual accounts prepared in accordance with German GAAP, subject to certain adjustments for book-tax differences, tax- exempt and non-deductible items, and other corrections (e.g. constructive distributions).

Corporations and other taxpayers keeping accounts must submit a standardized electronic version of their annual accounts including a reconciliation of the book-tax differences or an electronic tax balance sheet and profit and loss account (e-balance sheet) with their (electronic) income tax return.

Dividends received by German corporations or branches of non-resident corporations generally are exempt from corporate income tax regardless of how long the participation in the subsidiary has been held. However, 5% of the gross dividend is added back to taxable income as a non-deductible expense, resulting in an effective tax exemption of 95%. The exemption requires a minimum shareholding of at least 10% of the share capital at the beginning of the calendar year (acquisitions of 10% or more during the calendar year are deemed to have taken place as at the beginning of that year). The exemption is not granted to banks, financial service institutions and financial enterprises including holding companies (in respect of shares acquired with the intention of realizing a short-term profit from trading, “held for trading exception”), life and health insurance companies and pension funds, unless the EU parent-subsidiary directive or a tax treaty provide otherwise. The exemption generally is granted only insofar as the dividend has not been treated as a deductible expense at the level of the distributing company, irrespective of tax treaties providing otherwise (“anti-hybrid rule”).

The 95% exemption also applies to trade tax with the restriction that a minimum shareholding of 15% of the share capital (10% for dividends from companies resident in other EU member states) is necessary at the beginning of the calendar year. For dividends from non-EU resident

companies, a minimum 15% shareholding must have been held since the beginning of the calendar year in which the distribution takes place, and the subsidiary must meet certain activity requirements. Tax treaty provisions prevail.

Deductions

In general, all expenses are deductible if they have been incurred as a result of the company’s business operations. Certain expenses may be disallowed (e.g. expenses related to exempt income, income taxes and interest paid to the government on late income tax payments) or may be deductible only up to a limited amount.

⁷ <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-germanyguide-2017.pdf>

ii) Interest Thin capitalization rules/Interest Limitation rules

Generally, the deduction of interest expense exceeding interest income (net interest expense) is limited to 30% of the taxable earnings before net interest expense, tax, regular depreciation and amortization (tax EBITDA). The limitation applies to all interest regardless of whether the debt is owed to a shareholder, related party or third party. Excess interest may be carried forward indefinitely. An EBITDA carry-forward is generated if the taxpayer has net interest expense that is lower than 30% of the tax EBITDA. The excess EBITDA may be carried forward and used in the following five years when the net interest expense exceeds 30% of the current EBITDA. The 30% limit does not apply (with some related-party exceptions) where: (i) the annual net interest expense is less than EUR 3 million ("exemption threshold"); (ii) the taxpayer is not part of a group of companies ("group clause"); or (iii) the taxpayer demonstrates that the equity ratio of the German borrower does not fall short of the equity ratio of the worldwide group by more than two percentage points ("escape clause"). The equity ratio is determined based on the financial statements for the German business at the end of the previous financial year. A uniform accounting standard must be used for the German business and the group financial statements (primarily IFRS or, if no IFRS accounts are available, EU local country GAAP or US GAAP as a last resort).

The EBITDA threshold is calculated on the basis of the current year EBITDA of the German business (i.e. the year for which interest deductions should be claimed). A tax group for German tax purposes is treated as one business.

Interest expense exceeding the 30% limitation is non-deductible for German corporate income tax and trade tax purposes in the year of accrual (unless one of the exceptions applies) but may be carried forward. The interest carry-forward is subject to change-in-ownership rules (a direct or indirect ownership change of more than 25%/50% to one shareholder or a group of shareholders with similar objectives), which could result in a partial or complete forfeiture of all interest carry-forwards.

Interest expense disallowed under the interest deduction limitation will not trigger withholding taxes but may lead to double taxation, even within Germany.

The Federal Tax Court recently raised doubts as to whether the interest deduction limitation rule is in line with the German constitution and the case is currently pending before the Federal Constitutional Court.

The German Federal Tax Court has asked the German Federal Constitutional Court to rule on whether the German thin capitalization rules breach the principles of equality before the law and are thus unconstitutional. It remains to be seen how the Federal Constitutional Court will rule.

With introduction of thin capitalisation regime in Germany, the German Tax Authority is striving to counteract excessive debt financing arrangement of multinational enterprises operating in Germany and thereby trying to protect German tax base. In that sense it is a step in the right direction since it may tackle the issue of shifting of profits from India to lower tax jurisdictions by way of heavy payments of interest to the group companies. However, much depends on the manner in which the thin capitalisations rules are implemented and administered.

In case the interest is paid on the loan borrowed for capital expenditure and the interest is capitalized, whether appropriate amount in the depreciation amount of relevant asset to be considered for the purpose of disallowance under Income Tax Act.

iii) Depreciation

Depreciable or amortizable assets comprise fixed assets (tangible and intangible) with a useful life exceeding one year and diminishing in value over time through wear and tear. Land is not depreciable. The principal method of depreciation and amortization is the straight-line method. The declining-balance method is applicable only to movable fixed assets acquired or produced after 31 December 2008 and before 1 January 2011. Where economically justified, movable fixed assets may be depreciated according to the unit-of-production method. In the first year, the annual depreciation or amortization is reduced by one twelfth for each month that precedes the month of the acquisition or production.

Accelerated depreciation for exceptional wear and tear resulting from technical or economic causes is permitted only when the straight-line method is used. Acquisition or production cost of movable fixed assets of up to EUR 150 (exclusive of VAT) may be deducted immediately. Where the acquisition or production cost exceeds EUR 150, instead of capitalizing each asset, the taxpayer has the option to record them either:

- Individually and write them off immediately if the cost does not exceed EUR 410 (exclusive of VAT); or
- As a collective item and write them off over a period of five years if the cost of each asset does not exceed EUR 1,000 (exclusive of VAT).

The Ministry of Finance publishes guidelines on tax depreciation rates for a number of assets, based on their estimated useful lives. For buildings and purchased goodwill the rates are fixed by law. Industrial buildings are depreciated at a straight-line rate of 3% per annum. Goodwill is amortized over 15 years using the straight-line method.

Certain additional types of depreciation are available for small and medium-sized companies as a tax incentive.

Inventory may be valued at cost or, if lower and impairment is expected to be permanent, at market value. Last-in, first-out (LIFO) is generally acceptable for tax purposes; other cost flow assumptions, such as first-in, first-out (FIFO), are not allowed.

Write downs due to impairment are allowed only if the value of the asset is expected to be permanently lower. Write downs of shares in corporations by corporate shareholders and on certain shareholder loans are not tax deductible.

iv) Provisions

The creation of provisions generally is tax deductible. For certain types of provision, restrictions apply, e.g. for pension liabilities, provisions for anniversary bonuses and onerous contracts, and for acquired provisions. For tax purposes, measurement of provisions may not take into account future increases of prices or costs. Provisions must be discounted by 5.5% unless their duration is less than 12 months at the balance sheet date. For pension liabilities, a discount rate of 6% must be applied. The tax basis of a provision may not exceed its amount under German GAAP.

v) Losses

Losses of up to EUR 1 million may be carried back one year for corporate income tax purposes. No carry back is available for trade tax purposes. Losses not carried back can be carried forward indefinitely. However, the utilization of loss carry-forwards is restricted for annual profits exceeding EUR 1 million. Only 60% of the excess over EUR 1 million may be offset by the carried forward losses; the remaining 40% is taxed at the regular rates ("minimum taxation"). The minimum taxation rule applies for both corporate income tax and trade tax purposes.

All corporate income tax and trade tax losses, and loss carry-forwards, are forfeited if more than 50% of the shares in the loss corporation are transferred directly or indirectly to one acquirer (or to related parties of an acquirer) within a period of five years. In the case of transfers of more than 25% but less than 50% of the shares to one acquirer (or to related parties of an acquirer) within a five-year period, losses and loss carry-forwards are forfeited on a pro-rata basis. Acquirers acting together are treated as one acquirer in applying the rule. Transfers within a group do not trigger loss forfeiture if:

- (i) the acquirer directly or indirectly owns 100% of the shares in the transferor and the acquirer is an individual, a legal entity or a commercial partnership;
- (ii) the seller directly or indirectly owns 100% of the shares in the transferee and the seller is an individual, a legal entity or a commercial partnership; or
- (iii) the same individual, legal entity or commercial partnership directly or indirectly owns 100% of the shares in the transferor and the transferee company. Losses and loss carry-forwards also continue to be usable to the extent the loss corporation has built-in gains which are taxable in Germany.

Losses of a controlling entity or a controlled entity in a German tax group (Organschaft) cannot be deducted to the extent such losses are taken into account for foreign tax purposes at the level of the controlling entity, the controlled entity or any other person.

vi) Group relief

An Organschaft may be formed for corporate income tax and trade tax purposes by a parent entity and one or more of its subsidiaries. Under the Organschaft regime, taxable profits and tax losses of the group companies are combined at the level of the parent entity. This allows losses of group companies or loss carryforwards of the parent entity to be offset against profits of other group companies; loss carryforwards of group companies other than the parent company cannot be utilized during the Organschaft. The following conditions must be fulfilled to establish an Organschaft:⁸

The subsidiary company must be a corporation with its place of management in Germany and its registered office within the EU or EEA;

- The parent entity (either a German company, a German partnership maintaining a trade or business, a German individual or the German-registered branch of a foreign company) must hold shares in the subsidiary sufficient to give it a majority of voting rights, and the shares must be held in a German permanent establishment continuously from the beginning of the subsidiary's tax year; indirect shareholdings are taken into account if the shareholding provides the majority of voting rights in each intermediary;
- A profit and loss pooling agreement (PLPA) with a minimum term of five years must be concluded between the parent entity and the subsidiary and must become effective before the end of the tax year of the subsidiary for which the Organschaft rules will apply for the first time. A PLPA requires the subsidiary to transfer all profits made during the term of the agreement to the parent and the parent to cover all losses incurred by the subsidiary during that term; and
- The PLPA must be applied consistently during the entire term of the agreement, with any profit transferred to the parent and any loss used by the parent.

⁸https://www.jonesday.com/files/Publication/6f660ab8-97d0-4230-9c5b-71822ff023d9/Presentation/PublicationAttachment/dcd768bf-489c-4b58-8dbd-b510aaba5b69/Group%20Taxation_1.pdf

3] Tax incentives

Most types of investment or operational incentive in Germany are provided in the form of direct subsidies, grants, reduced-interest loans, public guarantees or silent participations. Various federal and regional programs exist. Incentives mainly focus on the promotion of business expansion and new investments, renewable energy (e.g. solar and wind energy), energy efficiency, electromobility and environmental protection, social housing, health care, infrastructure and agriculture, research and development (R&D) and recruitment, particularly of the long-term unemployed.

Current tax incentives include pre-investment and investment allowances for certain start-ups and for small and medium-sized businesses. Businesses in the manufacturing sector may apply for a partial relief from energy taxes. Purely electric vehicles are exempt from motor vehicle tax for five years after initial registration (10 years if the vehicle was initially registered before 1 January 2016); subsequently the tax is reduced by 50%.⁹

Start-up's attractiveness to investors has changed a lot since 2013. In that year Germany launched a grant, called INVEST, specifically designed for Business Angels.

The idea is that you can purchase shares in an innovative start-up and receive a 20% grant on their investment. When they invest, at least, €10,000 per Company. Angel investors can apply for an acquisition grant for investment up to €500,000 per year.

Since 2017, in case of the disposal of a share, angel investors can compensate the taxes paid on the profit with an exit grant of 25% of the profit. That applies to the shares whose purchase was carried out with the acquisition grant. The shares must be sold within 10 years and the exit grant must not exceed 80% of the acquisition cost of the acquired shares.¹⁰

To fulfil this advantage, your start-up must comply with the following standards:

- It must not be older than 7 years
- It must be an SME:
 - ≤ 50 employees
 - ≤ €10 Million Turnover
 - ≤ €10 Million Assets
- The Company has its headquarters in the EEA Area, but one branch must be permanently established in Germany
- Start-up must not be dominated by a parent company
- The Company must be innovative, i.e.:
 - Belong to an innovative sector listed by the Federal Office of Statistics.
 - Own an up-to-15-year-old patent

⁹ <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-germanyguide-2017.pdf>

¹⁰ <https://www.gtai.de/resource/blob/63830/e5c062e53cc63f50af45686ac20a854e/facts-figures-incentives-in-germany-en-data.pdf>

- Have received public support for research or innovation project within the 2 years preceding the application
- Proved to be innovative by the expert opinion of an independent assessor listed.

In Germany after acquisition and merger happen, losses suffered under a previous owner cannot be used by new investors to reduce a start-up's tax liability. Under the new rules, investors will be able to claim the tax breaks provided the business continues to operate.

This is to prevent companies being bought and gutted solely to take advantage of the tax breaks on losses carried forward.¹¹

Tax losses

Tax losses incurred within the original business activity may generally be carried forward without time limitation. Once profits arise, only 60% of annual taxable profits in excess of EUR 1 million can be offset by loss carry forwards under the restrictions of the so-called minimum taxation. As a result, 40% of the portion of profit exceeding EUR 1 million is subject to tax at regular rates, as the rules apply for both corporate income tax purposes and trade tax purposes. For corporate income tax purposes, an optional loss carry back is permitted for one year up to the maximum amount of EUR 1 million.¹²

Under the German loss-trafficking rule, tax loss carry forwards as well as current-year losses (for corporate income tax and trade tax) are forfeited entirely if, within a five-year period, more than 50% of the shares are transferred. Exceptions to the loss-trafficking rule may apply under specific conditions for group restructurings and to the extent sufficient taxable built-in gains are available, as well as in case the business is continued in a similar manner after the transfer (subject to various conditions). Loss carry forwards and current losses of a loss-making company are also forfeited in the course of a merger, change of legal form and liquidation of the company.

Expenses

The possibility to use setup or formation expenses before the original business activity of the enterprise begins depends on the legal form of the enterprise. As long as the startup is run by a single person or a partnership, initial expenses would be deductible from the initiator's personal income tax base. If the startup is established in the legal form of a corporation (for example a limited liability company), it is authorized to claim similar expenses incurred after the notarial certification of the statute. No transfer of earlier expenses (i.e. from a pre- incorporation phase) is possible

¹¹ <https://www.reuters.com/article/germany-tax-startups/german-law-to-allow-start-ups-to-claim-tax-breaks-on-losses-idUSL8N1BP2MR>

¹² <https://ginsep.co/tax-system-in-germany/>

4] Foreign Investment Policy

Germany is an attractive place to invest, owing not only to its location in the center of Europe, with access to the entire EU market and the markets of Central and Eastern Europe, but also due to its political stability, reliable legal system, positive social climate, excellent infrastructure, highly qualified workforce, and outstanding research and development (R&D).

The German government welcomes foreign investment and considers it an important pillar of economic development. Investment is promoted through Germany Trade & Invest (GTAI), the national economic development agency, and through regional agencies of the federal states.

In line with EU law, Germany follows the principle of free movement of capital and generally treats foreign investors the same as domestic companies. No special government approval is required for foreign companies investing in German property or acquiring German enterprises. Generally, there are no restrictions on the amount of foreign investment allowed, although some restrictions apply to investments in security-sensitive sectors (such as military weapons, other armaments or products with IT-security functions) and in the financial sector (banks and insurance companies). In addition, the government may prohibit or restrict acquisitions of enterprises or substantial shareholdings (25% or more) by non-EU/non-EFTA entities where the investment is expected to endanger public policy or public security. The rule is interpreted reluctantly and has not been applied since its introduction in 2009.

- The German Government is keen to attract foreign investment in the country. The Federal Government of Germany grants attractive tax subsidy to all foreign investors investing in Germany to acquire new movable and buildings for a period of 1 year. The tax subsidy at the rate of 25% to 27.5% is applicable to all small and medium sized companies (SME's) that employ about 250 employees.
- The Germany government grants special financial grants for foreign investors for conducting Research and Development. The financial aids are provided in the form of low interest rate loans. The interest rates are particularly low for SME's. Foreign investment investing in certain sectors in Germany can avail grants up to 50% of the eligible costs.

Special incentives provided by German government to foreign investors

The Government of Germany has laid out a statutory rule that all foreign investors are granted free access to investment in all sectors and are eligible to enjoy 100% ownership of the business even in recognized sectors that are under public domain. Foreign investors are allowed to invest in national bodies such as mail, telecommunication and other such sectors.¹³

¹³ <http://www.investineu.com/content/germany-%25E2%2580%2593-major-destination-foreign-investment>

5) Double Taxation Avoidance Agreements (DTAA) relief to business entity

Double Taxation Avoidance Agreements (DTAAs) were developed to address the problem that arose due to international double taxation. Double taxation occurs when a certain income is taxed in two different countries resulting in the income being taxed twice. These situations generally arise at international level when various countries make a claim to tax the same sum of income. The most common reason for such a situation to arise in an international transaction is due to the coinciding of a specific country's claim to tax the income based on the principle of territoriality with the other country's right to tax the same income based on the resident rule. This results in a situation where the taxpayer is required to pay tax on the same income twice due to a clash between the national laws that exists in different countries.¹⁴

DTAAs are formulated with the objective of preventing double taxation. These tax treaties are beneficial to the taxpayers as they intend to reduce the tax burden that would have existed without these treaties being in place. But, along with proving advantageous to the taxpayers, these treaties have also provided scope to abuse the existing international tax regime. Individuals and corporations who are not entitled to the benefits under such tax treaties have been observed taking advantages of the treaty arrangements that exists between other countries.¹⁵

These individuals belonging to the non-treaty country take advantages of such DTAAs by forming a business entity in the country in which the treaty exists for being eligible to take advantage of the tax arrangement that exists in the country and then channel the gain that was made under the treaty back to the country which is not a part of the treaty. The sole purpose of setting up a business entity in the treaty country is to funnel profits from that country to the non-treaty country. This act performed by the individuals and corporations of non-treaty country is called "treaty shopping"¹⁶.

It was imperative to prevent treaty shopping that was being practiced at a large scale by various individuals and corporations as a tool for evading tax liability. With an objective to prevent treaty shopping, a clause was introduced in the treaty that would restrict the benefits derived under the treaty to be availed only by a limited number of individuals and entities based on the proximity with the treaty country. This clause in the treaties came to be known as the 'Limitation of Benefit' clause¹⁷. The purpose of this clause was to exclude conduits and shell entities from availing the benefits under the treaty arrangement by recognizing considerable business nexus between the company and the country in which the treaty operates.

¹⁴ Aarati Krishnan, 'All You Wanted to Know About: Tax Terrorism', BUSINESS LINE October 13, 2014, < <https://www.thehindubusinessline.com/opinion/columns/All-you-wanted-to-know-about-Tax-terrorism/article20885792.ece>>(Last visited on 11THNovember, 2019)

¹⁵ <https://taxguru.in/income-tax/understanding-limitation-benefit-clause-dtaa.html>

¹⁶ Andrew Mitchel, 'Treaty Shopping and Anti-Treaty Shopping', International Tax Blog May 18, 2008, <https://intltax.typepad.com/intltax_blog/2008/05/treaty-shopping.html> (Last visited on 11th November, 2019).

¹⁷ 'How to Get Relief in case of Double Taxation', TAXGURU August 1, 2012, < <https://taxguru.in/income-tax/relief-case-double-taxation.html> >(Last visited on August 25, 2016).

i) Unilateral relief

In non-treaty situations or in tax treaty situations where the treaty provides for the tax credit method, German taxpayers with foreign-source income may credit foreign taxes paid against their income tax or corporate income tax liability (but not their trade tax liability) to the extent these foreign taxes relate to income that is subject to tax under domestic law, based on a per-country limitation. Excess foreign tax credits cannot be carried back or forward. As an alternative, the taxpayer may deduct foreign taxes paid as a business expense, which reduces the tax base for income tax and corporate income tax purposes, as well as for trade tax purposes. If, and to the extent that, the income is exempt from the relevant German tax (e. g. dividend income), no tax credit or deduction is possible.

ii) Tax treaties

Germany has a broad income tax treaty network, with most treaties following the OECD model treaty. Treaties on income and assets generally provide for relief from double taxation on all types of income, limit the taxation by one country of companies resident in the other and protect companies resident in one country from discriminatory taxation in the other. Germany's treaties generally contain OECD compliant exchange of information provisions. Certain treaties merely relate to the exchange of information and/or administrative assistance in tax matters.¹⁸

Foreign investors are free to repatriate capital, profits, royalties and fees and make all types of business-related payments.

For promoting and protecting investments, Germany has signed bilateral investment agreements with more than 130 countries, including China, India, Mexico, Russia and Singapore, and a treaty of friendship, commerce and navigation with the US. Further, the EU has recently concluded a comprehensive economic and trade agreement (CETA) with Canada which includes provisions on direct investments and on the protection of investments. Ratification by the EU member states is still pending but most parts of the agreement (excluding investment protection and the investment court system) are applicable on a provisional basis.

A reduced rate of withholding tax under a treaty may be applied directly at the time the payment is made if the income recipient presents to the payer a certificate issued by the Federal Central Tax Office before the payment is made.

There are numerous advantages to be had under Double Taxation Avoidance Agreement (DTAA), apart from the fundamental one of not getting subjected to double taxation on the same income and much-needed tax neutrality. Some of the other advantages are for the companies and citizens of the signatory countries are:¹⁹

¹⁸ <https://www.oecd.org/berlin/publikationen/43324465.pdf>

¹⁹ https://economictimes.indiatimes.com/why-you-should-be-aware-of-double-tax-avoidance-treaties/tetrapak_show/70143405.cms

- Tax deduction at source or TDS (i.e. lower withholding tax)
- Tax credits**
- Tax exemption
- Tax rate concessions

Withholding tax, also called a retention tax, is an income tax paid to the government by the payer of the income rather than by the recipient of the income. Paying it means the TDS burden on a taxpayer gets automatically lowered, and is applicable for incomes such as interest earnings, dividend earnings or royalty.

** (Most DTAA provide for tax credits in the country of operations or the source to avoid double taxation).

At the government level, DTAA helps in:

- Reducing the possibility of tax evasion in both or either of the signatory countries;
- Making each country more attractive to investors of the other.

Transfer pricing:

German tax law contains a set of rules that allows the adjustment of inter-company transfer prices. All of the rules are based on the application of the arms-length principle. Germany has implemented the Authorized Organization for Economic Co-operation and Development (OECD) Approach (AOA). Specific documentation rules apply for transfer-pricing purposes. Transfer pricing documentations need to be prepared if de-minimis thresholds are exceeded. On request of a tax auditor, the taxpayer is required to submit the transfer pricing documentation within 60 days (in the case of extraordinary business transactions, within 30 days). Non-compliance with these rules may result in a penalty.²⁰

²⁰ <https://www.pwc.com/gx/en/international-transfer-pricing/assets/germany.pdf>

6] Concluding Thoughts

1] Government policies that aim to encourage innovation may target start-up firms, as these firms are thought to be better able to produce innovative or entrepreneurial results. We articulated that develops an important reason to expect low take-up of such policies, in particular income tax incentives, by start-up firms. We reason that a capital-constrained start-up will only invest in income tax planning if the advantage—a possible future increase in the value of the firm attributable to higher after-tax income—exceeds the disadvantage of the reduction in the probability of success that comes from diverting resources from business spending to tax planning.

2] Start-ups, be they a business, a partnership or a corporation, must notify the tax authorities about their plans. An abbreviated finance plan must be prepared.

Keep in mind that start-ups should generally prepare a business and marketing plan. First, the entrepreneurs get an overview of what needs to be done and which costs have to be accounted for. Second, they acquire a better understanding of the nature and type of the business and market conditions, including what needs to be done in order to survive the crucial first years. Third, any bank or business angel will want to see a well-prepared business plan before lending money. Start-ups in Germany may be granted financial aid from the authorities, planning supervision and seminars as well as the arrangement of networking events.

3] Policies such as high tax burdens on labor, comparably high business taxation, and an overly complex individual income tax system make Germany's tax system less competitive and can hinder sustainable economic growth. Abolishing the solidarity surcharge for most income groups will partially alleviate the tax burden on employees. Similar reforms, particularly in the area of business taxation, would be essential to improve Germany's international tax competitiveness.

4] Although taxing startups in Germany is not the most profitable, you can benefit from registering your project in this jurisdiction due to its high reputation. German companies are attractive all over the world, and IT startups from Germany are more visible to international venture companies.

Starting a business in Germany is burdensome, but also lucrative.