TAX ADVISORY & COMPLIANCE

Alexander Krieger
Krieger

Basic principle

The German tax system is one of the most complicated in the world. There are many different types of taxes, such as corporation tax, trade tax, sales tax and many others. Income tax is just one of these taxes.

Income tax is applied only to the income of natural persons. The term "natural person" is defined as a physical person.

In the following paragraphs we will describe the taxation process itself and we will give a brief description of deductible expenses.

We will also discuss certain other fiscal burdens besides income tax.

Tax liability

There are two types of tax liability for natural persons:

There is the unlimited tax liability, which applies if a person is a tax resident of Germany. A person is considered a tax resident if they

- are domiciled in Germany, ie they maintain a home or dwelling in Germany for personal use with the intention to keep it on a regular basis

- their habitual place of abode is Germany, ie, they are physically present in Germany for a consecutive period of more than six months or with the intention to stay for that period, unless the stay is for visiting, recuperation or similar private purposes and does not last more than 12 months.

A German tax resident's entire income is taxed in Germany. This includes all income earned worldwide. However, there are double taxation treaties with numerous other countries to be considered. Such treaties aim to protect a person against double taxation of their income.

Limited tax liability applies if a person is not a German tax resident. A non-resident is taxed on certain German sourced income

The tax year in Germany is the calendar year

Special rule on tax liability

If a person is working in Germany for exactly half a year, their tax liability depends on whether they are working for the first or the second half of the year. If they are working during the first half of the year, they are subject to unlimited tax liability for the entire year. If they spend the second half of the year working in Germany, they are subject to limited tax liability for the entire year.

However, once they have been taxed in Germany, they may be taxed on a continuous basis in Germany. This scenario is governed by the Foreign Tax Act

But who pays the income tax?

Income from capital assets and income from employment is taxed at source. This means that the bank withholds the tax for capital assets and the employer withholds tax for its employees. The employer then pays the tax to the tax office.

In Germany, there is also an obligation to pay social security contributions. This means that health insurance is compulsory. These contributions are also retained by the employer and paid to the appropriate insurance companies. Privately insured persons are an exception to this rule as they pay their contributions directly to their insurer.

An employee receives their net income after these deductions.

Example:

Mr. Meier earns €5,000 gross. He is not married and does not have children. At the end of the month only €3,000 is paid into his bank account. The €2,000 difference consists of tax and insurance contributions withheld by his employer. Any additional payments, which arise when his tax return is lodged and the prior payments are not suffice, are paid directly by him to the tax office.

How is income tax calculated?

In Germany there are seven (7) different categories of income. These are income from

- Agriculture and forestry

- Business

- Self-employed work

- Non self-employed work (being employment income)

- Capital assets

- Renting and leasing

- Other income (e.g. from private disposals)

Taxable income from agriculture, forestry, trade and self-employment is the profit which results from the deduction of operating expenses from revenue received.

The income from employment, capital assets, renting and leasing as well as other income is calculated by deducting income-related expenses from revenue.

What are income-related expenses?

Income-related expenses are those expenses which are incurred by a person to engage in their employment and to earn income.

For example, this includes travel expenses to their workplace, where only one way travel can be claimed. A flat rate of €0.30 per kilometer is allowed as an expenses.

On average, employees in Germany work 230 days a year.

If they travel by bus or train, the costs of the ticket, instead of a flat rate per kilometer, may be claim and deducted against their income.

Further income-related expenses are things such as business apparel, tools or other items which are needed for work and which are not paid by the employer.

A lump sum for food/meals can be claimed if a person does not regularly work at the same location. This is currently 12€ per working day (8 hours away) or 24€ for a period longer than 24 hours. Different amounts apply for work travel to foreign countries.

Income-related expenses are then added up and the total amount is deducted from employment income earnt annually. An amount of 1,000€ can be deducted as a lump sum if no income-related expenses or less than 1,000€ in income related expenses have been incurred.

An example of income-related expenses is as follows:
Mr. Smith earns 24.000€ a year as an employee.
The distance between his work place and his home is 50 km each way. A claim for 0.30€ on the 50km easy route can be made and a deduction can be claimed of 15€ per day. This results in a total deduction of 3.450€ for 230 days during the tax year.

If he bought tools for 550€, the total deductible expenditure/ amount will be 4.000€.

Example 2 - income-related expenses:
Mr. Smith (still with a 24.000€ salary per year) lives next to his work. He cannot claim a flat rate for the journey to work, since this is claimed according to kilometers travelled to work.

Also, he has not incurred any other work related expenses. No costs were incurred due to the nature of his occupation

Nevertheless, he may deduct 1,000€ as income-related expenses for his occupation. The employer automatically takes this into account when calculating his pay.

Which further expenditures can be considered?

Additional special expenses can be deducted from income. These include contributions to social insurance, whereby health and nursing insurance contributions, school fees, donations, costs for child care, maintenance and certain costs for vocational training can be claimed if they are above a certain amount.

“Extraordinary personal expenses” may be partly deductible.

These are deductible if they exceed a reasonable limit and amount (depending on salary). In the case of particularly high medical costs, these may qualify as "extraordinary personal expenses" if they are incurred to protect the tax payer.

There is an additional allowance for children.

Example:

Mr. Smith falls ill and pays treatment costs in the amount of €7,000. We assume that with his income of 24.000€ the reasonable limit is 2.000€. We only can deduct those costs which are greater than 2.000€.

As such, an amount of 5.000€, being the amount that exceeds 2.000€, can be deducted.

The tax is determined as such with a departure of the income-related costs on the basis of a clearly lower amount.

Tax rate

German tax rates are progressive. This means the higher a person's income the, the higher the marginal rate of tax they pay.

The income tax rates in Germany are as follows

Income tax bracket (EUR)	Marginal Rate(%)
0-8,820 (0-17,640 joint income for married couple)	0
8,821 – 54,057 (17,641-108,114 joint income for married couple)	Gradually increasing from 14 to 41.99
54,058 – 256,303 (108,115-512,606 joint income for married couple)	42
Over 256,304 (over 512,607 joint income for married couple)	45

Example:

A salesman receives a salary of €2,000. A tax rate of approximately 25% applies to his salary.

If one compares this with a manager who receives a salary of 10.000€, then one will notice a big difference:

The tax rate of the manager will be about 42% tax of his income.

People with a lower income are not taxed in the same way as people with a higher income.

Basic allowance

In Germany tax is payable only if a person's income exceeds a certain amount (8,820€).

This allowance amount is deducted from every taxpayer who is subject to unlimited taxation in Germany.

Married couples

If a person is married, they will be taxed together with their spouse (provided they are both in Germany). This is advantageous because the tax burden is lower than if they were taxed as a single person.

This may sound strange as the two incomes are added together in the tax calculation. However, the sum of the two incomes is then divided by two and the tax on this amount is then multiplied again by two.

As tax rates are progressive, the tax payable is therefore lower.

Example:

Mr. Smith earns 24,000€, while his wife is at home and does not go to work.

For taxation purposes, the 24.000€ amount is divided by two (12.000€).

The tax rate applied to 12.000€ is about 4% (475€). This amount, multiplied by two, results in a 950€ tax.

If Mr Smith were single, income tax payable on 24.000€, with the tax rate being 15%, would be (3.507€).

Therefore, Mr Smith and his wife save 2.557€ in income taxes.

Social security contributions

Employed persons are required to pay contributions to the statutory health, nursing care, unemployment and pension insurance schemes. The employer pays 50% of the total contribution.

All individuals resident in Germany are required to take out health insurance. Employees with an annual gross salary of up to EUR 57,600 must be enrolled in the public sector health insurance scheme. The monthly contribution of 14.6% of the gross monthly salary (up to a salary ceiling of EUR 4,350.00) is divided equally between the employer and the employee who each contribute 7.3%. Employees whose gross salary exceeds EUR 57,600 may choose between the public sector health insurance scheme and a private health insurance scheme. These employees may claim from their employer an allowance for their health insurance that corresponds to the 7.3% share or amounts to half the contributions to a private health insurance scheme up to a maximum of EUR 317.55 per month.

All employees who are insured under the public health insurance scheme are required to take out nursing care insurance. The contributions, for employees with children, are 2.55% of their gross monthly salary, up to a salary ceiling of EUR 4,350.00.Employers pay one half of the contributions. Employees without children who are insured under the public sector health insurance scheme are required to pay an additional .25%, which is not paid by the employer.

Employers are required to pay statutory accident insurance for their employees for work related accidents and disease. Such insurance is based on the employee's gross salary and equates to approximately 2% of the gross salaries, but varies according to the employment industry in which the employer is classified based on such factors as the risk/danger of the employer's activities.

All wage and salary earners pay 3% of their gross salary, up to a maximum monthly earnings of EUR 6,350, in respect of unemployment insurance. Contributions are shared equally between the employer and the employee.

Also, the statutory pension scheme requires payment of 18.7% of a person's gross monthly salary, up to a salary ceiling of EUR 6,350.Employers and employees each pay half.

Employees who are working temporarily in Germany for a foreign employer may not be subject to German statutory social security if, and to the extent the EU social security regulations or bilateral social security agreements apply

Double tax treaties

In non-treaty situations or in tax treaty situations where the treaty provides for the tax credit method, a taxpayer with foreign sourced income may credit foreign taxes paid against their income tax to the extent that these foreign taxes relate to income that is subject to tax under German Law, based on a per country limitation. Alternatively, a taxpayer may deduct foreign taxes paid as a business expense, which reduces the tax base for income tax purposes. If, and to the extent that, the income is exempt from relevant German tax, eg dividend income, no tax credit or deduction is possible.

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. Germany's treaties generally contain OECD-compliant exchange of information provisions. Certain treaties merely related to the exchange of information and/or administrative assistance in tax matter

Treaties, in general, provide that income can either be made tax-free, tax-free with progression reservation (taken into account when determining the tax rate, but not taxed again), or paid tax can be credited against the tax arising again.

The applicable treaty defines which country is entitled to which tax payments.

Exit Taxation

If you have been subject to unlimited taxation in Germany for 10 years and move abroad, then hidden reserves (for example, if a property is worth more than the purchase price) in all corporations in which you have a stake of more than 1% must be disclosed and taxed in Germany

In addition to this regulation, there are many other special cases that may arise and are governed by the Foreign Tax Act.

AT A GLANCE

1. In Germany, only natural persons are subject to income tax
2. Under certain circumstances, a person is subject to limited taxation in Germany
3. If a person only works in Germany for half a year, their tax residency status depends on which half of the year they have worked in the country
4. Income tax is paid by the employer
5. There are generally 7 categories of income which can be taxed
6. Employees can deduct income-related costs, the minimum amount being 1.000€ per tax year

7. A person can deduct special expenses to reduce the income amount which is subject to income tax

8. Germany has a progressive income tax system: the higher the income, the higher the marginal tax rate

9. Not every single euro earnt is taxed directly, because every person with unlimited tax liability has a basic tax-free allowance

10. Married couples have a tax advantage over singles

11. Besides income tax, social security contributions are deducted from a person's income

12. Bilateral double taxation treaties are in place with many countries in order to avoid double taxation