B. Personal Income Tax

Natural persons (individuals) are liable to (personal) income tax which is subject to increase by a solidarity surcharge. If responsible for a business or trade, individuals are also subject to trade tax. Corporate taxpayers (in particular *AG, GmbH, KGaA*) are subject to corporate income tax and trade tax. The corporate income tax basically refers to many provisions of the personal income tax as far as the calculation of the tax base is concerned. The personal income tax rules could therefore be considered as a starting point for the corporate income tax system.

I. Liability for Personal Income Tax

1. Taxable persons: residents and non-residents

Liability to tax is set out in sec. 1 EStG (German Income Tax Act). Each natural person, as defined in sec. 1 BGB (German Civil Code), is subject to personal income tax if he is resident in Germany. Such an individual, or rather natural person, is also referred to as a "tax subject" (*Steuersubjekt*).

Partnerships, e.g., general partnerships (*OHG*), limited partnerships (*KG*), etc., are liable neither to personal income tax nor to corporate income tax. Revenue earned by such partnerships is taxed at the level of the shareholders, i.e., the shareholders are subject to tax on partnership earnings.

If a natural person maintains a domicile or habitual place of abode in Germany, he is fully liable to (income) tax (*unbeschränkte Steuerpflicht*) as set out in sec. 1 para. 1 EStG. The place of residence and the habitual place of abode are defined in sec. 8 AO and sec. 9 AO (General Fiscal Code). According to sec. 8 AO, persons shall be resident at the place at which they maintain a dwelling under circumstances from which it may be inferred that they will maintain and use such dwelling. Sec. 9 AO defines the habitual place of abode as: the place at which persons are present under circumstances indicating that their stay at that place or in that area is not merely temporary. An unbroken stay of no less than six months shall be invariably and from the beginning of such stay regarded as a habitual abode in the territory of application of the General Fiscal Code; brief interruptions shall be excepted. The previous sentence shall not apply where the stay is undertaken exclusively for visiting, recuperation, curative or similar private purposes and does not last more than one year.

If a natural person is resident in Germany, all income, whether derived in the country or abroad, is subject to taxation in Germany. A resident of Germany is liable to taxation in Germany on all earnings derived both within and outside the country (*Welteinkommensprinzip*). Therefore, German resi-

dents are subject to income tax on their worldwide income (unlimited tax liability). Resident spouses who live together are assessed as a single unit, except if they choose to be assessed separately.

Non-residents are customarily subject to taxation on certain income originating from a German source (limited tax liability), i.e., if an individual does not maintain a domicile or habitual place of abode in Germany, he is liable to tax only on income derived in Germany. This is set out in sec. 49 EStG.

> Example: Bennet B. lives and works in Venlo (Netherlands) and works occasionally in a restaurant in Aachen (Germany). Bennet is neither resident in Germany nor does he maintain a habitual place of abode in Germany; he is therefore only liable to tax in Germany on the income he acquires in the country (limited tax liability). His earnings from the restaurant in Aachen are subject to tax in Germany.

The principle of territoriality is combined with the principle of taxing one's worldwide income. Conflicts are primarily solved by tax treaties. Germany has entered into tax treaties with more than 100 countries. If no treaty is available, the German Income Tax Act provides the credit method for foreign-sourced income. To qualify for tax credit, foreign income taxes must be comparable to German income tax.

2. Taxable persons: extended liability of non-residents

Sec. 2 AStG (German Foreign Transaction Tax Act) contains special provisions which extend the tax liability of individuals who have been resident in Germany for at least five of the ten years prior to moving abroad. Regardless of the fact that there is no longer a domicile or habitual place of abode in Germany, the individual is subject to tax during the following ten years under certain preconditions; the most important of these preconditions is the level of taxation in the individual's new home country. If the tax levied by the new home country favours the individual by more than one third in comparison with the tax imposed in accordance with German personal income tax (low tax country), and if the individual maintains essential economic ties with Germany, a limited tax liability is extended substantively.

Sec. 6 AStG concerns capital gains from shares of individuals who have been resident in Germany for more than five of the last ten years before moving abroad. Even if these capital gains are not realised, an equivalent fictitious amount is subject to taxation. Taxation can be deferred on demand for a maximum of five years while paying an annual rate of 20 %. The tax liability ends if the absence is only temporary and the taxpayer returns to Germany within five to ten years, without selling the shares. If the taxpayer moves to an EU member state or EEA country, the tax imposed pursuant to sec. 6 para. 5 AStG is deferred ex officio, free of interest and without a

deposit of security. In such a case, the taxpayer has to report regularly to his most recent financial authority. These rules have been implemented with regard to the ruling of the ECJ in the case National Grid Indus (C-371/10).

3. Taxable persons: partnerships

Partnerships are treated as individual entities only for the sole purpose of determining the partnership's profits.

There are primarily two partnerships which must be differentiated: a general partnership and a limited commercial partnership (other partnerships are, e.g., the GbR and silent partnership). A general partnership (*Offene Handelsgesellschaft* – OHG) is a partnership in which all partners are liable for the debts of the company. A limited commercial partnership (*Kommanditgesellschaft* – KG) consists of one or more general partners and one or more limited partners. The limited partner is only liable in respect to his investment whereas the general partner of the limited commercial partnership is liable without limitation. The calculated profits are apportioned among the partners according to their respective stake. The shares of a partner of a partnership must be part of his own business income. The profit of these shares is taxed in the same way as if the individual partner had acquired the income directly.

4. Taxable income and calculation methods

The German Income Tax Act distinguishes between the following types of income:

(1) income from agriculture and forestry
(sec. 2 para. 1 sentence 1 nr. 1, sec. 13, sec. 13a, sec. 14, sec. 14a EStG);
(2) income from commercial trade or business
(sec. 2 para. 1 sentence 1 nr. 2, sec. 15, sec. 16, sec. 17 EStG);
(3) income from independent professional services
(sec. 2 para. 1 sentence 1 nr. 3, sec. 18 EStG);
(4) income from employment, including pensions and retirement income
(sec. 2 para. 1 sentence 1 nr. 4, sec. 19 EStG);
(5) income from private capital investment
(sec. 2 para. 1 sentence 1 nr. 5, sec. 20 EStG);
(6) rental income from immovable property and royalties
(sec. 2 para. 1 sentence 1 nr. 6, sec. 21 EStG); and
(7) other income
(sec. 2 para. 1 sentence 1 nr. 7, sec. 22, sec. 23 EStG).

Taxable income falling within the aforementioned separate categories must be assessed for each calendar year. The nature of the source of income will determine its classification. In the case of income classified as income from agriculture and forestry, from commercial trade or business or from inde-

pendent professional services ('profit income types'), the net income is subject to tax. In the case of the other categories of income ('surplus income types'), the surplus of income after income-related expenses is subject to tax. Regarding the first three categories of income listed, 'income' is defined as "profit income" (*Gewinneinkünfte*). Regarding the last four categories, 'income' is defined as "surplus income" (*Überschusseinkünfte*).

The overall income is reduced by special expenses and extraordinary expenses (burdens). The resulting amount of income is subject to taxation after the deduction of certain allowances in accordance with standard tax rates.

Sec. 3 EStG sets out income which is tax free. For instance, according to sec. 3 nr. 1 EStG, payments from health, accident and disability insurance are exempt from income taxation. Sec. 3 EStG enumerates other payments and income which is exempt from income taxation (e.g., scholarships, certain social distributions, etc.).

II. Income from Agriculture and Forestry

According to sec. 13 para. 1 and para. 2 EStG, income from agriculture and forestry is generated from the systematic cultivation of land and the utilisation of the products derived therefrom. This income also includes the profits arising from the sale of an agricultural and forestry enterprise. The cultivation of plants is not limited to agriculture but incorporates viniculture, horticulture, tree nurseries, and the growing of fruits and vegetables.

There are favourable provisions encouraging agriculture and forestry for social and political reasons. However, it can be difficult to determine whether the agriculture and forestry activities are being carried out as a direct result of the favourable provisions.

III. Income from Commercial Trade or Business

Income from trade or business is income from regular activity conducted to generate profit. This activity may be carried out by someone acting as a sole proprietor or as a partner; the latter includes the participation in partnerships. In principle, there are two categories of business income that must be analysed: income from trade or business; and income from independent professional services. It is important to distinguish between these two categories because of different rules concerning calculation of the tax base. Moreover, income from independent professional services causes no liability to trade tax whereas income from commercial trade or business does induce the liability to trade tax.

The category of income from trade or business comprises any income of merchants, traders, dealers and producers.

1. Definition of commercial trade or business

A commercial trade or business is not defined in sec. 15 para. 2 EStG, but the nature of activities carried out by such a trade or business is clearly outlined. Income derived from agriculture and forestry is explicitly excluded. Investment of one's own non-business assets does not constitute commercial trade or business activity. Generally, a business activity is deemed to focus on generating profits by purchasing and selling assets. Otherwise, the management of one's own assets is assumed to aim at preservation and appreciation of the source. It is important to distinguish correctly with regard to capital gains derived from private asset transactions. After special holding periods, there will be a tax-free period (a ten-year period for immovable assets and a one-year period for movable assets – except capital investment).

The following conditions must be met for generating income from commercial trade or business within the meaning of sec. 15 EStG: activities must be carried out autonomously (*selbstständig*), in other words, the individual must carry responsibility and be susceptible to risk; moreover, the activity must be sustainable; furthermore, the person must carry out the business on a long-term basis (intention to repeat/*Wiederholungsabsicht*).

Pursuant to sec. 15 para. 2 sentence 1 EStG, the business, or rather the business enterprise, must be run with the intention of realising a profit. If the business is only a hobby for the taxpayer, all of the earnings from that business cannot be regarded as income from commercial trade or business (*Liebhaberei*). Therefore, all of the potential losses of that business will not be deductible from earnings of that business. Moreover, the business must be part of the business market in the broadest sense (e.g., by having a shop or by advertising to the public).

The following examples demonstrate income from commercial trade or business: earnings derived from commercial activity such as a handicraft business or retail business; revenue deriving from a partnership, i.e., the earnings or losses drawn from the involvement in a business partnership; and the remuneration for managing partners of the partnership. According to sec. 15 para. 1 nr. 2 EStG, the remuneration must be taxed as income from commercial trade or business on the level of the partner (*Transparenzprinzip*).

Earnings from the sale, in whole or in part, of the business enterprise are considered to be income from commercial trade or business within the meaning of sec. 16 EStG. Furthermore, capital gains will be classified as income from commercial trade or business if a natural person has held not less than 1 % of the shares of a corporation for at least five years and sells all of the shares (sec. 17 para. 1 EStG).

Sec. 15 para. 3 EStG applies in those cases in which shareholders of a partnership gain income from commercial trade or business in addition to

that which they gain from independent professional services within the partnership (sec. 18 EStG) with the result that other categories of income are converted into income from commercial trade or business (*Abfärbewirkung*). Income from commercial trade or business inevitably leads to trade tax, too.

2. Commercial asset management (immovable property)

It can be very difficult to draw a line between private asset management on the one hand and commercial trade or business on the other. This is particularly true for short-term purchasing and selling of immovable property. From case law, a rule of thumb deeming asset management to be of a commercial character refers to three assets being bought and sold during a period of five years.

3. Dividends and gains from substantial participation

Similar problems occur in the context of private capital gains management. It can be challenging to differentiate between purely private asset management and commercial investment. Case law has not led to a reliable rule of thumb in this respect. There are very few decisions that deal with this issue. Certainty only exists as far as substantial participations are concerned. If an individual has owned more than 1 % of a company's share capital over a five-year period (sec. 17 EStG), participation gains are deemed to be income from commercial trade. Dividends distributed by this corporation are taxed according to the partial-income system at the shareholder level.

4. Special business expenses

In the context of special business assets (*Sonderbetriebsvermögen*), partners of a partnership are entitled to deduct special business expenses (*Sonderbetriebsausgaben*) in Germany. If the country of residence does not recognize the legal institute of special business assets – as is the case in most countries-foreign partners can profit from a double deduction of business expenses by claiming a deduction of the same expenses abroad. To prevent such a double dip, Germany introduced a new provision in 2017 restricting the deduction of special business expenses in cases in which the same expenses are also deducted from the tax base in another country (sec. 4i EStG). The prohibition does not occur if the deduction reduces income which is included in the tax base of the other country. In such a case, the taxpayer has to prove that the income has been included in the foreign tax base. To some extent, this measure corresponds to BEPS Action 2.

IV. Income from Independent Professional Services

The income from independent professional services is derived in particular from freelance work and other independent activities (self-employment). Independent professional services are offered by trained professionals and academics. This category of income does not induce the liability to trade tax.

Income from independent professional services has the same criteria, or rather conditions, as income from commercial trade or business (sec. 15 para. 2 EStG). The only difference is that the person who derives income from independent professional services conducts his activity completely independently and based on specialist knowledge. The majority of self-employed or freelance persons belong to this category. Sec. 18 para. 1 nr. 1 EStG defines certain professions which belong to this group; doctors, veterinarians, dentists, lawyers, notaries, tax advisors, architects and engineers are just some examples of persons who derive income from independent professional services.

A "mixed activity" also exists in cases in which an independent professional service is bound to an activity related to commercial trade or business. Both activities have to be inseparable to be a "mixed activity". Revenue has to be taxed as income from independent professional services pursuant to sec. 18 EStG if the activity related to commercial trade or business only represents a small percentage of the whole activity.

If several natural persons merge to form a partnership, all of these persons must fulfil the necessary criteria of an independent professional service ("freelancer"). Otherwise, the earnings of the partnership have to be taxed as income from commercial trade or business (sec. 15 EStG).

In addition, taxpayers who generate income from independent professional services have a choice concerning the determination of profits or income. For income resulting from a commercial trade or business, the general method to determine the profit is the *accrual accounting method* or, simply put, the "*business asset comparison method*",[13] which calculates taxable income as the difference between the assets' net value at the end of the business year and that at the end of the previous business year increased by the value of withdrawals and reduced by the value of contributions.

Taxpayers deriving income from independent professional services can choose the method of the determination of profits. Besides the accrual accounting method (sec. 4 para. 1 EStG), taxpayers who derive income from professional services can apply the *cash flow accounting method* (sec. 4 para. 3 EStG) under which taxable income is calculated by deducting related expenses from the gross income.[14] It is based on the cash flow, or

13 Also referred to as "net worth comparison method".

14 Also referred to as "net income method".

rather the 'inflow and outflow principle' (*Zufluss- und Abflussprinzip*) related to sec. 11 para. 1 EStG. (This method takes the net income into consideration). The thresholds for commercial annual profits (less than € 60,000 and turnover less than € 600,000) do not apply (see also B. IX.).

V. Income from Employment

1. Wages and benefits in kind

Earnings derived from a professional appointment or contractual relationship between employer and employee are income from employment (sec. 19 EStG). Earnings or wages from employment are acquired by an employee in regard to his employment. The income tax of the employee has to be retained by his employer. This means that taxes that must be paid by the employee are withheld by the employer who passes the taxes on to the tax office (sec. 38 et seq. EStG). The relevant income tax is increased by the solidarity surcharge and contributions to social security. The taxes withheld are an employee's prepayment of the income tax for the calendar year.

The contractual relationship between the employer and the employee himself must fulfil certain criteria to generate income from employment:
– the employee is employed and has to follow orders of the employer;
– the employee is entitled to holiday; and
– the employee draws wages.

On occasion, benefits in kind may be obtained from an employment. These benefits in kind are classed as employment income according to sec. 19 para. 1 sentence 1 nr. 1 EStG. At times, it might be difficult to distinguish between income from employment and other categories of income.

> Example: Research assistant Christian S. who is employed by University X occasionally writes and publishes scientific articles in scientific magazines. As a research assistant at University X, Christian S. derives income from employment because he is on the payroll of the university (sec. 19 EStG). In contrast, the earnings of his published articles are income from independent professional services within the meaning of sec. 18 EStG because Christian S. does not have to follow the orders of his employer (professor, etc.) when he independently writes a scientific article.

2. Work-related costs

In general, all work-related costs are deductible by the employee. Due to sec. 9 para. 1 sentence 1 EStG, work-related costs are considered to be all expenses which arise from procuring and maintaining income (from employment). Nevertheless, work-related costs are only deductible to a certain extent. According to sec. 9a EStG, an employee is allowed to claim

a € 1,000 lump-sum deduction if the employee's work-related expenses do not surpass € 1,000.

A standard deduction is available for commuters (regardless of whether they are employees or self-employed persons). Pursuant to sec. 9 para. 1 sentence 3 nr. 4 EStG, an employee who travels between home and work is entitled to a deduction of € 0.30 per kilometre for the single distance between home and work (i.e. one way) in total. The mode of transport has no effect on the deduction. Furthermore, it is irrelevant if expenses are actually incurred in this context or not. The standardised deduction is capped at € 4,500 except for cases of private car use in which higher costs occur.

If the taxpayer's home office is the centre of his work, the costs for this office are fully deductible. A maximum limit of € 1,250 applies in cases of no availability of office space with the result that the taxpayer has to set up his own home office.

There are other work-related costs which may be deductible as income-related expenses such as necessary costs for the maintenance of two households, moving expenses if these expenses derive from the start of a new job and costs for work-related tools and clothes if these are only used for the employment.

There is an ongoing discussion concerning work-related childcare costs. From 2006 until 2011, the legislator allowed a limited deduction to encourage young families. This decision was motivated by socio-political reasons. In 2012, the legislator decided to alter the rules. Today a limited deduction of childcare costs is only granted in the field of personal deductions.

3. Managing director

Payments to managing directors (board members) are income from employment. Therefore, these directors are treated as employees with the result that sec. 19 EStG applies.

4. Expatriates and cross-border workers

No special rules apply to expatriates besides the exit tax imposed by means of the extended limited liability to non-residents (sec. 2 AStG). However, some tax treaties contain special rules for cross-border workers (i.e., employees, directors, artists/sportsmen and persons employed by the government). Regardless of the fact that a cross-border worker is due to limited tax liability as far as he earns money in Germany (source state), the state of residence may be entitled to tax him on his worldwide income. The principle of territoriality will not apply in such cases.

Art. 13 para. 5 DTC Germany-France, for instance, follows this approach. An alternative approach grants compensation to cross-border workers. Recently, such a compensation rule was included in the treaty Germany

concluded with the Netherlands (2012). As a result of this rule, cross-border workers resident in the Netherlands and working in Germany are compensated for the disadvantage arising from the fact that they cannot deduct mortgage interest from their taxable income in Germany.

VI. Income from Capital Investment/Capital Gains

1. Private investment

Income from capital investment includes all earnings from investments which are not otherwise classified as a different category of income. Private capital investment income differs from the other categories of income in that this income is based on (existing) wealth. This category of income derives from the capital yield arising from the allocation of capital. The yield on capital may be one of the following:

- dividends deriving from (shares of) corporations, gains from investments, income from jouissance shares/rights (*Genussrechte*) (sec. 20 para. 1 nr. 1 EStG);
- income from a silent partnership (sec. 20 para. 1 nr. 4 EStG);
- interest generated by mortgage, debts or other claims related to capital investments (sec. 20 para. 1 nr. 5–7 EStG); or
- gains as an option writer (*Stillhalterprämien*) (sec. 20 para. 1 nr. 11 EStG).

There are other sorts of income which belong to income from private capital investment in terms of sec. 20 EStG, including capital gains from financial instruments as well as profits from the sale of securities, profits from futures and options, etc. The holding period of shares etc. is not taken into consideration. The distinction between shares held for at least one year with the result that the capital gains of the shareholder were exempt from income tax and those shares held for less than one year has been abandoned by the German legislature with the implementation of the *Abgeltungsteuer* in 2009.

The earlier distinction between speculative capital gains from shareholdings subject to taxation (holding period of one year or less) and capital gains exempt from taxation (holding period of more than one year) has been discontinued.

A deduction according to sec. 20 para. 9 EStG (*Sparer-Pauschbetrag*) is provided for taxpayers who derive income from private capital investment (sec. 20 EStG). This lump-sum deduction is only applicable annually and amounts to € 801. The *Pauschbetrag* is increased to € 1602 in case of joint assessment with a spouse. Income-related expenses are not taken into account and thus are not deductible.

In 2009 the taxation in relation to income from private capital investment changed to the extent that this income is subject to a flat withholding tax (*Abgeltungsteuer*) with a standard tax rate of 25 %. By adding the solidarity