Working Party No. 2 on Tax Policy Analysis and Tax Statistics

TAX REFORM

(Note by Germany)

This note is submitted to the Working Party No.2 FOR DISCUSSION under item IX of the Agenda for their meeting to be held on the 14-15 November 2000.

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There have been substantial tax reforms since the new government came to power in 1998. The main projects have been the ecological tax reform, which has increased the taxation of energy to decrease the burden of labour, the Tax Reduction Act 1999/2000/2002 adopted last year, the Tax Reform 2000 and some other minor reform measures.

**Ecological tax reform**

Last year the government completed the phasing-in of an ecological tax reform. As from 1 April 1999, an electricity tax of 0.02 DM per kilowatt-hour was introduced, the mineral oil duty on motor fuels was raised by 0.06 DM and – as a one-off measure – on light heating oil by 0.04 DM per litre, and a charge of 0.0032 DM per kilowatt-hour was imposed on natural gas.

The ecological tax reform is to continue in stages up to the year 2003, retaining the special arrangements for production enterprises. This will incorporate an increase of 0.06 DM a year in the rate of duty on motor fuels, while the tax on electricity will be raised by 0.005 DM per kilowatt-hour each year. This approach will generate incentives to use resources more sparingly and in an economically more appropriate manner.

The funds generated by the ecological tax reform will be used to reduce the pension insurance contribution rate, thus relieving the pressure on labour as a production factor. The success of this approach is indicated by the reduction of the pension insurance contribution rate from 20.3 per cent to 19.3 per cent since the end of 1998.

Expected revenues and the projected reduction of the pension insurance contributions produced by the ecological tax reform:

<table>
<thead>
<tr>
<th>Year</th>
<th>Volume of Revenue</th>
<th>Reduction of the pension insurance contributions compared to 1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>8.4 billion DM</td>
<td>0.8 %</td>
</tr>
<tr>
<td>2000</td>
<td>17.4 billion DM</td>
<td>0.9 %</td>
</tr>
<tr>
<td>2001</td>
<td>22.8 billion DM</td>
<td>1.2 %</td>
</tr>
<tr>
<td>2002</td>
<td>28.1 billion DM</td>
<td>1.5 %</td>
</tr>
<tr>
<td>2003</td>
<td>33.5 billion DM</td>
<td>1.8 %</td>
</tr>
</tbody>
</table>
At the same time, structural change in the German economy will be speeded up. For instance, better use will be made of the potential for energy conservation and market access for environmentally-friendly technologies will be improved. In this way, tax policy will help to achieve ecological restructuring of the German economy.

Tax reduction programme

The German government has managed to launch quite an ambitious tax reduction programme. In the period from 1998 to 2005 taxpayers will benefit substantially from net tax relief of more than 93 billion DM thanks to the Tax Reduction Act, the Tax Reform 2000 and other reform measures

The Tax Reform 2000 alone will provide tax relief of 62.5 billion DM. Families, dependent employees and small and medium-sized businesses will be the main beneficiaries of the reform: around 33 billion DM of the total volume of reductions will be to the benefit of private households and a good 23 billion DM to the benefit of SMEs.

Thus private consumption will be stimulated and investment will be encouraged – two essential requirements for more growth and employment. The emphasis placed on families and employees with low and medium incomes as well as SMEs will enhance the fairness of the tax system. The same is true for the abolition of numerous exceptions which tended to be used most extensively by top earners. German tax legislation will become more readily manageable and more transparent.

Central elements of the Tax Reform 2000

Reduction of income tax

The basic personal allowance will be increased from approximately 12,300 DM in 1998 in three steps to 15,000 DM in 2005. Over the same period, the basic rate of tax will fall from 25.9 to 15 per cent while the top rate will be cut to 42 per cent. In 1995 the top rate will be applied only to taxable income in excess of DM 102,000.
Reduction of corporation tax and a change in the system of taxing corporations and shareholders

The corporate tax rate will be cut to a uniform 25 per cent as from 2001. Currently the rate depends on whether the profits are distributed (30 %) or retained (40%).

As regards the taxation of dividends, the full imputation system will be applicable in 2001 for the last time. From 2002 onwards the full imputation system will be replaced by the so-called half-income system in order to make cross-border investment more attractive. Under this system, only half of the distributed profits of a corporation will be included in the shareholder’s personal income tax base. In return, it will no longer be possible to credit the corporation tax paid by the company against the shareholder’s income tax.

Capital gains from the sale of shareholdings between corporations will generally be exempted from tax. In order to prevent abuse, however, various restrictions will be imposed, among them a minimum holding period of one year. The new rules will come into effect as from the tax year 2002.

As before, private shareholders will be able to sell their stakes in corporations after a minimum holding period of one year without paying tax unless they have a substantial interest. However, the threshold for what constitutes a substantial interest will be reduced from 10 per cent to 1 per cent as from the tax year 2002. If the sale is subject to tax, for example when shares are sold within the one-year holding period or represent a substantial interest, the half-income method will apply from 2002 onward.

Example:

Married taxpayers receive 100.000 DM income from other sources. The profit from sale is 500.000 DM. They own 15 per cent of the capital stock:

Married couple sell their 15 per cent share of the capital stock

<table>
<thead>
<tr>
<th></th>
<th>before the reform</th>
<th>after the reform</th>
</tr>
</thead>
<tbody>
<tr>
<td>year 2000</td>
<td></td>
<td>year 2002</td>
</tr>
<tr>
<td>income from other sources</td>
<td>100.000 DM</td>
<td>100.000 DM</td>
</tr>
<tr>
<td>profit from sale</td>
<td>500.000 DM</td>
<td>500.000 DM</td>
</tr>
<tr>
<td>inclusion of the realised capital gains into the calculation of taxable income</td>
<td>500.000 DM</td>
<td>250.000 DM</td>
</tr>
<tr>
<td>income tax</td>
<td>235.185 DM</td>
<td>138.347 DM</td>
</tr>
</tbody>
</table>

Tax reduction for this couple: 96.838 DM

- charge the income tax at lower rate
- only half of the realised capital gain from the sale of their stakes in corporation is included in the calculation of taxable income
These fundamental reform measures will improve the international competitiveness of the German economy.

The change in the system will result in simple and transparent taxation of corporations and their shareholders, creating a system that is in line with European practice and less prone to abuse. The systematically consistent tax exemption of capital gains resulting from the sale of shareholdings will provide companies with the necessary flexibility to optimise their shareholding structures.

**Specific reform measures benefiting unincorporated companies**

*Unincorporated companies are quite important for the German economy.*

Unincorporated companies will benefit from the significant cuts in income tax rates mentioned above.

All sole traders or entrepreneurs with personal liability deriving income from trade or business and liable to local trade taxes (Gewerbesteuer) will be afforded relief from trade tax as the trade tax will be credited against their income tax liability in a standardised form. Their income tax will be reduced by an amount corresponding to 1.8 times the assessment base (Gewerbesteuermessbetrag) for trade tax. As the method of determining profits for tax purposes remains unchanged, the trade tax will still be deductible as operating expenditure. As a result, the majority of SMEs will see full relief from trade tax.

The tax-free allowance for the sale or closure of a business will be raised from 60,000 DM to 100,000 DM. In addition, the “half-average tax rate” abolished in 1999 will be reintroduced for entrepreneurs retiring from business. (This is in anticipation of a planned parliament decision in accordance with the Bundesrat resolution) This benefit can be claimed once in a lifetime by entrepreneurs having reached the age of 55.

The restructuring of unincorporated companies by way of a tax-neutral transfer of undisclosed reserves will be facilitated by reintroducing the so-called “Co-partner tax remission”. This provision will make the transfer of a company easier and help SMEs to cope with inter-generational succession.

**How this tax relief is to be financed**

In the measures adopted to finance the reform, principal emphasis has been placed on restricting existing tax depreciation arrangements:

- The declining-balance tax depreciation rate for movable assets will be reduced from 30 to 20 per cent.
- The depreciation rate for company buildings will fall from 4 to 3 per cent.
- As from 2001, the official depreciation rate table will be based on more realistic useful life periods.