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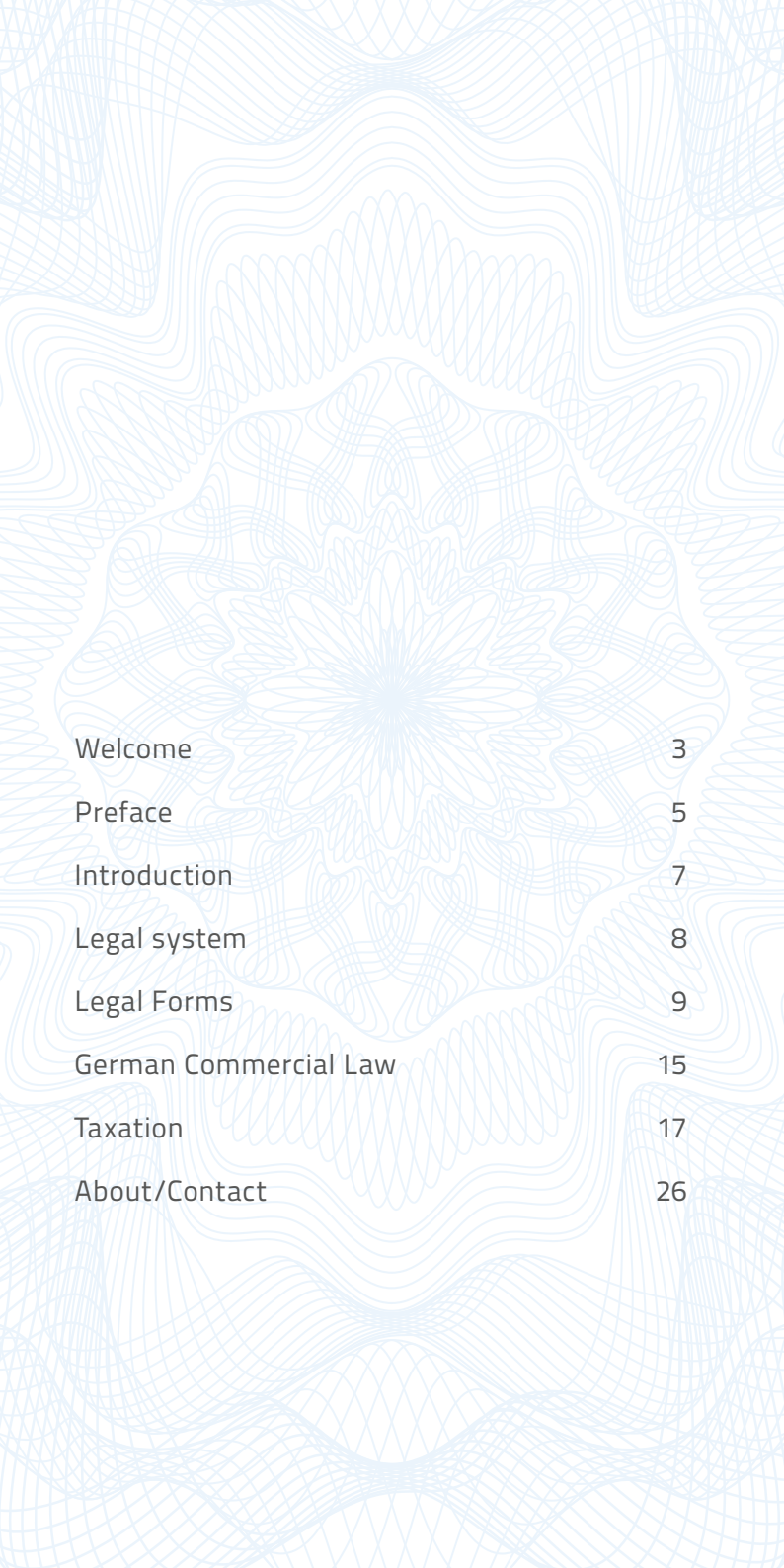
Doing Business in Germany

Tax and Legal Basics

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Welcome to the HCSM Group

HCSM is a tax consultancy and auditing group located in Wiesbaden. We offer professional solutions for Finance & Accounting, Controlling & Reporting, Tax Consultancy and Transactions & Restructuring.

As a medium-sized office, we know the issues and problems of our clients in the German "Mittelstand" exactly. Therefore we deliver understandable decision-making support and efficient solutions.

We work in individual teams of accountants, tax consultants and technical staff with many years of experience and ensure the consistency of our consulting.

Our partners and employees work with high personal commitment and great passion for our clients. We place great emphasis on the personal and trusting dialogue and are always available for you.

Our international Association

As a member of EuropeFides, we are also able to support clients who need help in the development of international strategies.

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Taxes, Law, Audit and Advisory in Europe

Preface

This brochure is aimed at international companies wishing to set up a business in Germany and German-based companies operating international.

To set up a business it is crucial to know issues such as geographic location, infrastructure, political and social stability and wage levels. It is also important to understand the legal and tax system of the country and the differences in tax treatment before making your final decision.

We hope you will find this brochure informative and inspiring.

We advise that this brochure may not be a proper basis for final decisions regarding the circumstances included in this brochure. This brochure serves orientation purposes only and gives insights in possible managerial decisions. For bespoke legal and fiscal advice, please feel free to contact us.

Introduction

Recent surveys confirm: Despite the financial and economic crisis around Europe, Germany remains an attractive and competitive site for foreign investors. Important advantages are seen in a well developed infrastructure, an excellent level of education among the workforce and a strong social climate. On the other side critics point out the complexity of the German tax and legal system as well as the relatively high tax burden and labor costs.

Nevertheless Germany, located in the middle of Europe, is also its strongest economic power and one of the most important market participants in the world economy (GDP 2012: 2.6 trillion Euros). Its position is built on a high volume of direct investments and a firm orientation towards export. Important trade partners are European countries like France, United Kingdom, Italy and the Netherlands, followed by Asia and Northern America.

Leading industries are mechanical engineering, automotive construction and chemistry. But also new high tech industries are increasingly successful like laser, nano and medical technology, which profit from an excellent research environment. In many cases small and medium-sized enterprises are driving forces.

As in most industrial countries the GDP growth is currently on a low but positive level (2012: 0.7 %). At the same time inflation remains low (2012: 2.0 %).

Legal System

The constitutional law defines Germany as a democratic and social federal state. German legislation is based on the Constitution and by that bound to inalienable human and citizen rights. While human dignity is protected as the overall principle, further essential rights like the freedom of arts and research, the rights to form unions and the right of owning property are explicitly guaranteed and enforceable by independent courts.

The court of jurisdiction depends on the matter of dispute. While civil law suits have to be trialed in civil courts, public law suits have to be trialed in certain courts, e. g. law suits concerning taxation have to be brought to the responsible fiscal court.

Legal Forms

Overview

Entrepreneurs in Germany can choose between several kinds of legal bodies to pursue their business. Because of different treatments in the field of liability, capital requirement or taxation, the choice of the right investment vehicle can be as important as the site decision itself.

Partnerships

GbR (Gesellschaft bürgerlichen Rechts – Civil-Law Partnership)

Civil-law partnerships can be constituted by an agreement of two or more partners running a small business. In case no other agreements are made, the civil code defines basic rules for representation, the rights of partners and reasons for the ending of partnerships. Certain form requirements are not compulsory.

Civil-law partnerships are able to carry out business activities as long as they do not reach the scope and quality of merchants. If so, they have to be registered either as general or as limited partnership.

The civil-law partnership requires neither minimum capital nor registration in the commercial register. On the other hand, the partners are personally liable for the liabilities of the partnership.

If the partnership agreement is not limited in time, termination of each of the partners will cause the end of the partnership.

OHG (Offene Handelsgesellschaft – General Partnership)

The general partnership is based on an agreement between two or more partners. The general partnership is regulated by the commercial code, leaving the partners room for deviating agreements, e. g. the regulations for representation or the allocation of profits. The partnership agreement is not bound to a certain form.

The general partnership does not require minimum capital, but the partners are personally liable for the partnership's liabilities.

General partnerships are deemed merchants and have to obey the according rules of the commercial code. They also have to be registered with the register of commerce.

Representation and management can be carried out by each of the partners or a group of partners together. They are subject to non-competition clauses.

The OHG will end, if the partnership agreement has determined a specific time for its existence, if all partners agree on termination, in case of the opening of insolvency proceedings or in case of a corresponding court decision. The OHG does not end with the death or insolvency of one of the partners.

KG (Kommanditgesellschaft - Limited Partnership)

The limited partnership follows the principles of the general partnership. The important difference is the distinction between the general and the limited partner. While the general partner has the same rights and obligations as under the general partnership, the limited partner has both less rights and less liability.

The limited partner is not entitled to participate in the management or the representation of the partnership. His influence is restricted on certain controlling rights. He is primarily obligated to pay in his capital contribution. If completely fulfilled, his liability for debts of the partnership is limited to that contribution.

The general partner can be incorporated. Because of its impact on the liability, the partnership has to specify the limitation through its business name, e. g. "GmbH & Co. KG".

Limited partners are not subject to non-competition clauses.

Corporations

GmbH (Gesellschaft mit beschränkter Haftung – Private Limited Company)

The GmbH is the most common legal form in Germany. GmbHs can be constituted by a notarized agreement of one or more partners. They can be founded for any business purpose and are deemed merchants irrespective of their actual business.

The GmbH requires a minimum capital of 25,000 Euros, which can be contributed in cash or under certain restrictions as contribution in kind.

As subcategory of the GmbH the investor can choose to set up a UG (Unternehmergesellschaft (haftungsbeschränkt) – entrepreneurial company (limited liability)), requiring a seed capital of at least one Euro. Therefore, profits of the UG have to be partially retained until the minimum capital requirements of the GmbH are met.

By registration with the register of commerce the GmbH becomes incorporated. From that moment partners are normally not liable for liabilities of the company. The limitation of liability causes the distribution of capital and profits to be restricted.

The GmbH acts through its organs. The partners' assembly determines one or more managing directors. The managing directors do not have to be partners. A supervisory board becomes mandatory when reaching a minimum number of 500 employees.

Shares of GmbHs can only be traded by notarized

contracts. Therefore, a trade market for GmbH shares does not exist.

AG (Aktiengesellschaft – Public Limited Company)

The AG is a legal form often used by large companies having or planning to have a broad capital basis. Shares of AGs can be listed at stock exchanges and change hands without certain form requirements. Because of the easy transfer and to establish a reliable standard, the organization is widely regulated leaving little room for deviating agreements.

Setting up an AG requires a notarized agreement made by one or more founders.

The minimum capital has to be 50,000 Euros, which can be contributed in cash or under certain requirements as contribution in kind.

When registered with the commercial register, an AG becomes incorporated. From that moment the founders are normally not liable for liabilities of the company. The limitation of liability is the reason that the distribution of capital and profits is restricted.

The AG acts through its three organs. Leadership, management and representation are assigned to the executive board. The appointment of the executives as well as the arrangement of their contracts and their supervision is assigned to the supervisory board. The members of the supervisory board are periodically elected by the shareholders at the annual general meeting and if the number of employees exceeds 500 additionally by the workforce.

The annual general meeting enables shareholders to participate in the company directly by making use of their voting and question rights. Among other things the assembly has to approve the appointment of members of the supervisory board, the appropriation of balance sheet profits, the appointment of the annual auditor, changes of articles of association or capital increases and reductions.

The European version of the German AG is the SE (Societas Europaea). It is basically comparable, but deviates in some structural characteristics like the formation of the management and supervisory board.

Branches

Merchants have to register dependent parts of their company with the register of commerce. Branches do not have legal capacity themselves.

German Commercial Law

The German commercial law is part of the civil law. It determines the rights and obligations of merchants. The basic idea of German commercial law is that persons running commercial businesses can, because of their professionalism and experience, be treated by stricter standards. The effect shall be a faster settlement of transactions and thus a more effective business environment.

German General Accounting Principles – German GAP (HGB)

As part of the commercial law, the German GAP (HGB) requires merchants to keep diligent records of their business transactions and to take annual inventories. Additionally, merchants have to prepare annual financial statements complying with HGB. The level of details stated depends on the size of the company measured by the balance sheet totals, the annual turnover and the average number of people employed during the year.

| | Small | Medium | Large |
|-----------------------------|------------------|-------------------|-------------------|
| Balance Sheet Totals | <€ 4.840 million | <€ 19.250 million | >€ 19.250 million |
| Annual turnover | <€ 9.680 million | <€ 38.500 million | >€ 38.500 million |
| Average number of employees | <50 | <250 | >250 |

A cornerstone of the HGB is the protection of creditors. This approach may often result in precautionary valuations, especially compared to the International Financial Reporting Standards (IFRS).

Financial statements under German GAP

Annual financial statements have to be prepared by every entrepreneur and business form either under the German GAP or at least under the German general tax code ("Abgabenordnung"). The annual financial statements consist of the balance sheet, the income statement and, if applicable, the notes. Corporations additionally have to prepare a management report. If listed at the stock market, companies also have to disclose a cash flow statement and a statement of changes in equity forming a unit with the annual financial statements.

Companies with subsidiaries have to prepare consolidated financial statements. If the parent company is listed or listing is applied for, the consolidated financial statements have to follow the rules of the IFRS. If the parent company is not listed the management can opt between HGB and IFRS.

Depending on their size and legal form, companies have to disclose their reports and to be audited by professional auditors.

Taxation

Income Tax

The German income tax is determined by the German Income Tax Act (ITA). It covers all natural persons with residence or habitual abode in Germany. They are subject to tax with their complete domestic and foreign income. Without residence or habitual abode in Germany, natural persons are subject to tax with their domestic income only.

By reference to the ITA, the Corporate Tax Act (CTA) also imposes most of the rules concerning the determination of income on corporations liable to the CTA.

Partnerships themselves are not liable to income tax (only to trade tax). Their income is determined separately based on the income of the partners being liable to the ITA or the CTA. Each interest in the partnership is then taxed on the level of the relevant partner. People with full liability to tax can derive income from seven main categories of activity. Income can result from

- Agriculture and forestry
- Industrial or commercial activities (trade business)
- Self-employment activities
- Employment
- Savings and investments (capital gains)
- Renting and leasing
- other sources, e. g. capital gains not being part of the aforesaid categories.

If income from the last four categories is generated in the course of the business of one of the first three categories, it is allocated to the former category.

The ITA allows taxpayers to deduct certain expenses either directly from the revenues of each income category or from the total income in form of special or extraordinary expenses.

Deductible (business) expenses have to be coherent with the income of the taxpayer. The list of deductible items in the ITA is not exhaustive. Nevertheless, in some cases deduction is restricted, inter alia in the case of interest expenses.

Special and extraordinary expenses are expenses without reference to any sort of income. Special expenses are specific costs in the taxpayer's private sphere and allow for full or partial relief where these expenses are mandatory, such as church tax and expenses for social security. Extraordinary expenses also belong to the private sphere. Certain private expenses are allowed to be deducted if they are above the assumed average amount other taxpayers usually bear, (e.g. excessive health and medical costs).

On the other hand, there are non-deductible expenses including parts of the expenses for hospitality services or presents to third parties.

Generally the taxable income is taxed by a progressive tax rate beginning with 14 % for taxable income above 8,131 Euros and ending with 45 % for taxable income beyond 250,000 Euros. A magnificent exception from the progressive rate is given since 2009 for income

from savings and investments. A fixed rate of 25 % has replaced the former progressive rate. The deduction of individual expenses has been abolished and replaced by a fixed exempt amount of 801 Euros. Taxes for this kind of capital gains are normally withheld at the source.

For taxpayers obliged to do bookkeeping, the ITA contains mandatory rules for the creation and valuation of balance sheet items. Regularly this fact results in a deviation of the annual result determined by German-GAP from the result determined by the ITA. A tax-based balance sheet will in some cases practically be indispensable.

Taxpayers who are married can choose to be assessed together. In consequence the effect of the progressive tax rate can be mitigated due to the application of the splitting rate and combined tax exempt amounts. The more distinctive the income between the spouses is, the more they can profit from the splitting.

Corporate Tax

The taxation of corporations is based on the German Corporate Tax Act (CTA). It encompasses legal entities, such as AG, SE or GmbH as well as their foreign equivalents, associations, regional bodies and foundations. Entities having their registered office or place of management in Germany are fully liable to corporate tax. Without that however corporations acting in Germany can be liable to corporate tax due to permanent establishments. Permanent establishments are permanent facilities to serve the head office (seated abroad). They do not have legal capacity.

German partnerships, such as OHG or KG are not subject to the CTA. Some companies are explicitly exempt from tax.

The CTA refers to the ITA-rules concerning the determination of income supplemented by corporate tax rules. Entities under the CTA are taxed with 15 % of their taxable income.

Contractual relationships between companies and their shareholders have to be agreed upon and conducted at arm's length. Otherwise the CTA assumes hidden profit distributions, which may cause unwanted tax arrangements.

Generally, capital gains like dividends or profits from the disposal of stocks can be obtained tax-exempt at the level of the receiving corporation. Still 5% of the gains will be deemed non-deductible business expenses and therefore increase the income.

The acquisition of shares or voting rights of corporations can lead to a partial or complete perdition of losses carried forward of the acquired entity. Partial loss will occur, if the investor acquires more than 25 % of the shares or voting rights of the same entity within a period of 5 years. Besides that crossing the barrier of 50 % within 5 years means the total perdition.

Individuals and corporations can constitute corporate tax groups with other corporations effecting that the income of both companies is counted together, which enables the parent company directly to use tax losses of the subsidiary or vice versa. Setting up a cor-

porate tax group is bound to strict requirements. The parent company and its subsidiary have to conclude a profit transfer contract having duration of contract of at least 5 years beginning with its announcement in the commercial register. The contract has to be conducted as agreed upon. Earlier termination will regularly result in a retroactive invalidity of the tax group from its beginning.

Trade Tax

The German trade tax is based on the German Trade Tax Act (TTA) and is an important instrument for community financing. Object of taxation is the domestic commercial business establishment. Liable to tax can be individuals, partnerships and corporations. While individuals (and by that partnerships) can claim relief for paid trade tax in their income tax declarations, corporations have to face a definite tax burden in addition to their corporate tax.

The determination of the trade tax is based on the profits or losses determined by the ITA or CTA. The result is then raised by certain additions and shortened by certain deductions. Common additions are interest or lease expenses. An important deduction exists for real estate property. Following this, the income can be reduced by 1.2 % of the standardized tax value of the real estate property.

The offsetting of profits with losses carried forward is restricted. Profits exceeding the amount of 1 million Euros cannot be completely offset with losses carried forward. This results in minimum taxation. However, the remaining loss carried forward can be

used in the next year. There is no time limitation on using tax loss carried forward.

The basic tax rate is 3.5 %. This rate has to be multiplied with a municipal rate being at least 200 %. In most communities it can be assumed to be around 400 % resulting in trade tax burden of approx. $(3.5\% \times 400\% =) 14.0\%$. For communities being in competition with each other by setting up their own rates, site selection appears to be a tax relevant process with the potential to diminish future tax expenses.

Taxpayers who have permanent establishments spread over more than one community, have to divide their income after application of the tax rate upon the concerned communities depending on the sum of salaries paid in each permanent establishment.

Value Added Tax

The Value Added Tax (VAT) is implemented in the European system of VAT-taxation. German VAT is mainly charged for supplies and services provided in Germany. It is an indirect tax, paid by the receiver of the service and owed to the fiscal authorities by the provider.

The supplier or service provider has to provide for the correct reckoning of the VAT. Therefore, he has to classify his service and to check whether it is due to tax and at which rate.

Suppliers shipping goods between countries of the European Union have to consider the rules regarding the inner-community taxation.

The standard tax rate is 19 %. Besides that, several services are taxed at the lower rate of 7 %.

In numerous cases the tax is not owed by the provider, but by the receiver (reverse charge taxation). This is why the receiver of invoices has to check diligently whether or not he himself owes the tax in order to avoid tax evasion.

The receiver of supplies and services is regularly entitled to deduct input tax from his own VAT-liability, provided that he is using the input services to generate taxable output services (that are not tax-exempt).

The VAT-Code enables companies to form VAT-groups. The result is that subsidiaries of the parent company are treated as permanent establishments for VAT-purposes with the effect that intra-group services are not taxable. Intended or not VAT-groups arise, when subsidiaries are financially, organizationally and economically integrated into the parent company.

Entrepreneurs with small turnovers are exempt from charging VAT.

Land Tax

The German land tax enables communities to charge real estate within their community with a certain annual tax. This value is subject to the land tax rate ranging between 0.26 % and 0.6 % (for the old West German states). It is then multiplied by the applicable municipal rate, which is about 400 % average.

Real Estate Transfer Tax

The purchase and transfer of real estate in Germany is liable to real estate transfer tax (RETT). The RETT is also applicable, if 95 % of a partnership is transferred onto new partners within a 5 year period, provided the partnership owns domestic real estate property. A similar situation concerns the transfer of corporate shares. If domestic real estate is held by a corporation, a transfer of 95% or more of the shares can affect taxation.

In the case of transfer through purchase the basis of assessment depends on the compensation agreed on.

The standard tax rate is 3.5 % and is owed by the purchaser. The federal states are able to determine a deviating rate by law. Thus, most of the states have rates about 5 %.

Inheritance and Gift Tax

Transfers of estate by inheritance or gift are subject to German inheritance and gift tax. The law as well covers family foundations that are subject to tax after periods of 30 years.

The taxation of inheritance and gifts basically follows the same scheme. Depending on the objects transferred, their tax value and the relationship of the heir or the donee to the testator or donor, taxation varies.

On the one hand, close relatives are preferably treated by having the highest personal tax-exempt amounts. On the other hand, certain estate objects

are partially or completely free from tax, like real estate used as own residence or companies going on with business and keeping a certain level of wage expenditures in the following years.

The personal tax rate is determined by the tax class and the value of the inheritance. The tax class derives from the relationship of the heir or donee to the testator or donor. It ranges from 7 % to 50 %.

About HCSM Group

We offer customized solutions for your industry

We offer customized solutions in the areas of Finance & Accounting, Controlling & Reporting, Tax consultancy, Transactions and Restructuring & Auditing for our clients of all industry sectors.

For us, this is not only the use of industry-specific tools such as chart of accounts, indicators and questionnaires. Our partners and professional staff bring a deep understanding of the industry that enables the dialogue and the solutions to your problems.

Our industry focus in detail:

- Real estate industry
- Leasing & Finance services
- Trade and Services
- Industry
- IT & Technology
- Health and Healthcare professions
- Freelancers and Tradespersons
- Entrepreneurs
- Private Clients

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