

Income Tax Reform Discussion in Germany

I. INTRODUCTION

In Germany, income taxation comprises two separate regimes. These are one for individuals, set out in the Income Tax Act (*Einkommensteuergesetz*) and, one for certain companies (corporate entities), set out in the Corporate Tax Act (*Körperschaftsteuergesetz*). The company tax rules for calculating the tax base are, however, cross-referenced to the individual income tax rules. Accordingly, depending on the form of a business, the tax on business income is determined either under the (individual) income tax law, for example, in respect of partnerships and their partners, or the corporate tax law, for example, in respect of limited liability companies.

An erroneous trend in German income and corporation taxation has been apparent since 1945. Specifically, income tax has been misused as a tool for social policy objectives and engineering and for redistribution purposes. The income tax law also contains special rules for different sources of income, which lack a comprehensive and coherent approach and result in differences in tax burdens. In addition, inflation has given rise to increasing tax burdens. This has produced

growing opposition from taxpayers who have engaged more and more in tax planning and are more and more creative in circumventing the tax provisions. In response, the tax legislation has become more detailed and complex – too complex to be properly understood and enforced.

As a result, there is a need for income tax reform¹ to prohibit provisions that are designed to encourage particular non-tax related behaviour or to grant subsidies and to reduce the law to its pure and basic principles, especially with regard to the "ability-to-pay principle". As tax administration is mass administration, standardization and simplification are also essential to make the tax laws enforceable and workable. If not, the law might as well just be "paper law" with no practical effect. Finally, tax rates should be reduced to compensate for the negative effects of "silent" progression and inflation.² In the light of these developments, tax reform plans are currently being discussed in Germany.

¹ The need for modernization is almost unanimously agreed on, see, for example, K. Tipke, *Die Steuerrechtsordnung*, Vol. II, Second Edition, (Cologne: Dr. Otto Schmidt, 2003), at pp. 612 et. seq and J. Lang, "Prinzipien und Systeme der Besteuerung von Einkommen", *Deutsche Steuerjuristische Gesellschaft*, Vol. 24 (2001), at pp. 49 and 73 et. seq.

² With regard to silent progression, see V. Stern, "Der Tarif muss auf Räder - Heimliche Steuererhöhungen vermeiden", 91 *Deutsche Steuerzeitung*, 9 (2003), at p. 294.

II. THE PRINCIPLE OF EQUALITY AND THE CONCEPT OF A SYNTHETIC INCOME TAX

Income tax can be designed either as a synthetic, comprehensive income tax or as an analytic, schedular income tax.³ In the former, a single tax rate schedule is applied to a taxpayer's accumulated total income and, in the latter, separate rates are applied to schedules consisting of different categories of income. The German synthetic income tax system consists of seven different categories of income such as "income from a trade or business", "income from employment" and "income from capital investment". With regard to the taxation of capital gains, private gains and the gains of companies are distinguished. The former are taxed only if linked to speculative activities, but the latter are subject to tax as business income. The net results of all the categories of income are aggregated in determining the taxable base to which the various tax rates are applied. The tax rates applied to the different categories of income are the same, no matter to which category the income belongs.

Previously, the international consensus was that a synthetic income tax was the preferred model. Increasing pressure, especially on corporate income tax rates,

³ L. Burns and R. Krever, "Individual Income Tax", in: V. Thuronyi (ed.), *Tax Law Design and Drafting*, Vol. 2, (Washington: International Monetary Fund, 1998), at pp. 495 and 496.

has, however, resulted in a change. Scandinavian countries, such as Norway and Sweden, have introduced a dual income tax system in reaction to increased tax competition. Under a dual income tax system, all capital gains (and corporate profits) are taxed at a, generally lower, proportionate rate, whilst employment income is taxed progressively. As an example of this trend, countries such as Finland, Lithuania, Norway and Sweden tax corporate profits and capital gains at low tax rates of between 15% and 28% and employment income at progressive tax rates of up to 59%.⁴

In Germany, the Council of Advisors to the Federal Ministry of Finance, following an extensive analysis of several tax reform concepts, has proposed a modified dual income tax system.⁵ With regard to efficiency and simplicity, a progressive rate system is clearly to be preferred to a proportionate and/or linear rate system. A significant difference between the proportionate rate for business income and a progressive rate for labour income may, however, conflict with the principle of equality.

⁴ For updated information, see the recent information on the web sites of the Ministries of Finance or the tax administrations of the respective countries, i.e. www.vero.fi, www.finmin.lt, www.odin.dep.no/fin and www.skatteverket.se.

⁵ Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung/Max-Planck-Institut für Geistiges Eigentum, Wettbewerbs- und Steuerrecht/Zentrum für Europäische Wirtschaftsforschung, Reform der Einkommens- und Unternehmensbesteuerung durch die duale Einkommensteuer, *Schriftenreihe des Bundesministeriums der Finanzen* (Federal Ministry of Finance series), Bonn, Vol. 79 (2006).

In addition, there should not be any difference in the taxation of labour income, regardless of whether derived by a dependent employee or an independent businessman. Accordingly, the total profit of a business for tax purposes would have to be divided into two elements, i.e. the return on the capital invested, taxed proportionately, and the remuneration for the businessman's activities, taxed progressively. This distinction might cause significant difficulties and complex classification issues and is the "Achilles heel" of a dual income tax system. It is, therefore, not surprising that the specific problem of dividing income from self-employment into capital and labour income is central to an ongoing discussion on a national tax reform in Norway. The problems have even caused the Norwegian Minister of Finance to call for a reduction in the difference between the tax rates on labour and capital.⁶

Another problem with a dual income tax system is whether or not it should be possible to offset losses between both types of income. Although the system of imposing tax on net gains (*objective net principle*, which recognizes deductible expenses incurred by a taxpayer in deriving gross income) might require such a provision, adjustments would be necessary due to the different tax rate levels. At the same time, the supporter of a dual income tax concept limit allowable deductions and personal tax reliefs to income from employment. Such a limita-

⁶ The speech of the Norwegian Minister of Finance to the Norwegian British Chamber of Commerce on 23 February 2004, see www.norway.org.uk.

tion might, however, discriminate against those taxpayers with income only from capital. The personal relief might also not be fully effective in these cases. To prevent such a system from being ruled out by the German Constitutional Court, taxpayers should at least be allowed to opt for progressive income taxation.

Taking all of these problems into account, a dual income tax system is unlikely to contribute to the creation of a simpler, executable tax system in Germany. For instance, following the principle of ability to pay, EUR 10,000 earned by a businessman should not be treated differently from EUR 10,000 earned by an employee, pensioner or shareholder. Inequities between taxpayers earning different types of income should, therefore, be avoided. Consequently, two recent scientific drafts of a modified income tax law (the Karlsruhe draft and the Cologne draft⁷) argue for a synthetic income tax system, treating different types of income equally and conforming to the principle of equality incorporated into the German constitution.

⁷ P.Kirchhof et al., "Einkommensteuergesetzbuch", *Schriftenreihe des Instituts für Finanz- und Steuerrecht, Forschungsgruppe Bundessteuergesetzbuch*, Vol. II, Heidelberg 2003; J.Lang et al., *Kölner Entwurf eines Einkommensteuergesetzes*, Cologne 2005.

III. CAPITAL-ORIENTED VERSUS CONSUMPTION-ORIENTED TAXATION

Under a traditional, capital-oriented income tax system, taxation is linked to the acquisition of capital. *Consumable* income is taxed, regardless of whether or not and how the income is consumed. The intention behind an individual's activities, however, does not necessarily have to be consumption, but could also be increased prosperity, expressed by the accumulation of property. A substantial argument for consumption-oriented taxation is its calming effect on inflation. Under taxation based on discrete periods, the overall lifetime income of a taxpayer who saves his income is taxed more heavily compared to a taxpayer who consumes immediately.⁸ Supporters of consumption-oriented taxation, therefore, suggest adjusting taxes for inflation either via an exemption for interest (income from capital investment) or by means of "downstream" or "postponed" taxation (which provides for an exemption in respect of investments from tax and postpones taxation until the time of accrual and/or return).⁹ A complete exemption of income from capital investment would, however, go far beyond an

⁸ Some examples are given by M. Rose, "Konsumorientierung des Steuersystems - theoretische Konzepte im Lichte empirischer Erfahrungen", in G. Krause-Junk Junk (ed.), *Steuersysteme der Zukunft, Jahrestagung des Vereins für Socialpolitik 1996*, (Berlin: Duncker & Humblot, 1998), at pp. 247 and 249 et seq.

⁹ J. Lang, "Entwurf eines Steuergesetzbuches", *BMF-Schriftenreihe* (Federal Ministry of Finance series), Vol. 49, (Bonn: 1993), at paras. 560 and 580 et seq and C. Dorenkamp, "Nachgelagerte Besteuerung von Einkommen - Besteuerungsaufschub für investierte Reinvermögensmehrung", Dissertation, Berlin, Duncker & Humblot 2004.

adjustment for inflation. A more appropriate solution would, for example, be to exempt only the normal rate of interest from the tax base or, even better, the rate of inflation corresponding to the amount of income saved.

When comparing capital-oriented and consume-oriented taxation not only the scope of the tax base differs, but also, notably, the timing of taxation is different. To prevent taxpayers from permanently concealing accumulated wealth, a complex system would have to be installed to ensure "end-of-life" taxation. Movements of capital, savings and the liquidation of savings would have to be traced and examined and exit taxes would have to be levied.¹⁰ If government revenue is not to be put at risk, the transition to a system of downstream taxation could, therefore, only be a gradual one, accompanied and backed-up by interim arrangements and provisions.¹¹ In the short term, downstream taxation can only realistically be introduced in respect of the taxation of pensions, annuities and similar income. Tax-free amounts and the tax rate scale would, however, have to be adjusted with regard to wage and price indices to prevent silent progression.

¹⁰ In the light, however, of ECJ, 11 March 2004, Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie* many types of exit taxes are likely to violate the fundamental freedoms contained in the EC Treaty, at least where supranational taxation is guaranteed.

¹¹ With regard to the recently introduced downstream and/or deferred taxation in respect of pensions, the legislator provided for interim measures and "fade-outs" until 2040! See *Alterseinkünftegesetz*, 5 July 2004, Federal Law Gazette, 2004 I, 1427.

IV. NON-CYCLICAL TAXATION

German income taxation is characterized by a system of annual assessments and a taxable period that corresponds, in most cases, to the calendar year. The income realized by a taxpayer within a taxable period, such as the calendar year, may, however, be higher or lower than the average annual earnings over the same period. The periodic nature of income tax is not a substantive but is, rather, a formal, technical principle. Dividing a person's total income realized over his lifetime into several periods always leads to a certain arbitrariness.

Specifically, a taxpayer realizes income to finance his lifetime consumption independent of any (annual) tax period. The ability-to-pay principle, therefore, requires a non-cyclical/cross-periodical approach that takes into account the taxpayer's lifetime income (a lifetime-oriented system of taxing income). As a result, the offset of losses across several taxable periods has nothing to do with tax reliefs or subsidies, but, instead, corresponds to the ability-to-pay principle.

V. SIMPLIFICATION THROUGH STANDARDIZATION

The income tax law is designed to be applied to, and to cope with, a large number of cases. Tax administration can, therefore, be described as *mass admini-*

stration. In regulating mass administration, the legislator has a certain leeway to apply a more general approach by using standardization and generalizations to make the law enforceable. Tax law provisions must also be linked to facts and situations that can be understood and easily proven. Keeping this in mind, the recognition of personal or non-personal expenses inevitably complicates the tax system. Tax relief for personal expenses can, therefore, only be applied in a standardized way and employment expenses should be recognized on a lump-sum basis designed broadly and realistically enough to cover all expenses in most cases.

Simplification and standardization are particularly justified with regard to borderline expenses that have elements of both employment expenses and personal consumption. The distinction between employment and/or business expenses, on the one hand, and personal consumption, on the other hand, is a consequence arising from the principle of taxing net income and stems from the ability-to-pay principle. In doubtful cases, the tax administration must make the distinction by reference to presumptive taxation. When it comes to basic human needs (for example, housing, food and entertainment), the *additional* expenses caused by employment and/or business activities can only be recognized as a lump-sum deduction. Consequently, expenses such as entertainment expenses, subsistence costs, relocation costs and expenses for commuting between home and work, can be standardized.

Once a flat rate is introduced and income tax rates are significantly reduced, the discussion regarding the necessity to deduct these expenses from the tax base could be reopened and a prohibition of the deductions might be justifiable. Although, from a technical point of view, the rules on tax rates, on the one hand, and those on the definition of taxable income, on the other hand, are completely different. Although a total denial of the deductions could probably not be compensated by rate adjustments, a certain interdependence still exists. The lower the tax rate and the less taxpayers are burdened by tax laws, the more discretion legislators have to standardize deductions and to simplify the tax base. Standardized and simplified provisions must, however, be designed realistically and should cover the average, not the atypical, case.

VI. TAX RATES

Since 1955, the German income tax law has contained a "progressive tax formula" (*progressiver Formeltarif*) instead of a "graduated rate scale" (*Stufentarif*). Whereas other tax rate systems are restricted to linear relationships, a progressive tax formula expresses the level of tax by way of complex mathematical formulas. The German progressive tax formula is probably unique in the world and is not very transparent, as the marginal tax rate is not apparent. Worldwide, most tax systems apply a more transparent and comprehensible

graduated rate scale, dividing income into portions and applying different (increasing) rates to each portion of income. A graduated rate scale with rates of, for example, between 15% and 35% is more transparent and is currently supported by both, scientists and practitioners. To avoid silent progression, Sec. 3(2) of the Cologne draft, following the US approach, provides for the automatic adjustment of the rate scales based on the consumer price index of the Federal Statistical Office.

When asked to give reasons for a progressive tax rate, most proponents refer to the ability-to-pay principle, arguing that with growing income an individual's ability to pay grows disproportionately. They believe that tax should be designed progressively to correspond to the extent to which parts of income are needed to satisfy basic needs and to provide for humane existence. It is also argued that, although the rich pay a comparatively greater share of their income in tax, the sacrifice they make is similar to a taxpayer earning less and paying a smaller percentage of his income in tax. So far, there is, however, no convincing evidence that the sacrifice is, indeed, comparable.

Whereas the German income tax law of 1958 may have conformed to such a reasoning of sacrifice, modern developments no longer support this line of argument. The legislator in 1958 wanted to tax 95% of taxpayers at a proportion-

ate tax rate of 20% and to tax only the richest 5% of taxpayers progressively.¹² Consequently, originally only a few taxpayers, with 21 times the average income, fell into the highest tax bracket. Since then, the marginal income to which the highest tax bracket is applied, has not been increased and has been reduced (to EUR 52,152 in 2005). Currently, even taxpayers with an average income are taxed progressively and the highest tax bracket applies to income only 1.3 times above average income. This silent progression cannot be justified, neither by the reason of sacrifice nor by reference to the welfare state, as progressive tax rates are an admissible but not a necessary tool in realizing social justice and/or equity.

The ability-to-pay-principle does not require a progressive tax rate system, but can also be realized through a proportionate tax rate system. A progressive tax rate system, along with the system of periodical taxation, however, results in inequality over time. Under a progressive rate system, a taxpayer's overall lifetime income might be subject to an unequal tax burden. Consequently, there is a need for special rates in respect of specific situations, for example, when a taxpayer sells all his business assets. A progressive tax rate system also provokes non-economically motivated tax planning to avoid progression, for example, by dividing income between family members. In addition, high income tax rates

¹² *Entwurf eines Gesetzes zur Änderung steuerlicher Vorschriften auf dem Gebiet der Steuern vom Einkommen und Ertrag und des Verfahrensrechts, BT-Drucksache 3/260, at pp. 37 and 43.*

inevitably cause lobbyists to argue for tax privileges and exemptions for special groups of taxpayers, making the tax law even more complicated.

As a result, more and more countries, especially those in Eastern Europe, are introducing proportionate rate systems and a "flat tax".¹³ In Russia, income is taxed at only 13% and the Slovak Republic has a single tax rate of 19% for both employment income and business profits. Both Estonia and Latvia apply a proportionate rate of 25% and 24%, respectively, to corporate and personal income. Corresponding to these international developments, there is a growing number of experts who support the introduction of a flat, proportionate rate system in Germany. Following the case law of the German Constitutional Court, all the proposals provide for an exemption of a family's basic personal expenses through a tax-free threshold. No matter which proposal is analysed, the recognition of personal expenses always leads to an indirect progression.

A proportionate rate clearly results in a simplification of the tax law, especially if the difference between the income tax rate, on the one hand, and the corporate tax rate, on the other hand, is abolished or, at least, reduced. A major reason for the existence of diverging rates is that, due to international tax competition, traditional progressive tax rates are combined with an extensive interpretation of

¹³ On the idea of a flat tax, see R. Hall and A. Rabushka, *The Flat Tax*, Second Edition, (Hoover Institution Press:1995).

the principle of taxing net income. German constitutional law requires the tax legislation to be neutral with regard to the legal form of a business. In determining the corporate tax rate, the legislator cannot, therefore, disregard the marginal income tax rate.

Although there appears good reasons to retain the traditional differentiation between income and corporate tax law, adjusting the respective rates would be major progress. A flat tax would help to simplify tax law and, therefore, justify certain limitations of the principle of net income taxation, at least with regard to borderline expenses that have elements of both employment expenses and personal consumption. There would also be no need to grant entities and/or businesses the right to choose between income tax and corporate income tax.

Introducing a flat tax could also end the controversial discussion on the joint assessment option for spouses that has, to date, been provided for to reduce the effect of the progressive tax rates. The withholding tax on income from capital could also be a final tax without any infringement of the system of a synthetic income tax. Taxpayers could chose between gross withholding and the application of an individual average tax rate. Accordingly, a system of costly and bureaucratic information returns would be avoided without compromising the principle of equality. Applying a general, final withholding tax at the same rate as the proportionate tax rate would not, however, allow for the recognition of

both employment and/or business expenses and personal expenses. Lump-sum tax-free amounts would not be sufficient to compensate for this. Consequently, tax withholding should be individualized and an individual average tax rate should be applied.

VII. THE INTERLINKING OF TAX WITHHOLDING AND SELF-ASSESSMENT

In general, it is difficult to design a withholding tax as a final tax because it is normally withheld from gross income instead of the net amount and does not allow for the recognition of deductible expenses, unless these are standardized. At least with regard to employment income, the withholding regime could, however, be adapted in such a way so as to apply an individual tax rate for every employee, thereby ensuring the recognition of most deductible expenses. An individual withholding regime would offer the opportunity to combine the withholding procedure with the tax assessment procedure. A tax compliance strategy, based on a widened withholding regime and a revised and coherent system of information returns could also help to realize a cooperative administrative procedure. Tax compliance literally means, "to fulfil one's fiscal duties". A compliance strategy is intended to motivate taxpayers to cooperate and to obey the law. A cooperative compliance strategy could be all the more important as,

in the long run, the necessity to check tax returns is expected to decline and the effectiveness of the enforcement is anticipated to increase.

A tax compliance strategy requires both a functioning risk management and better service for taxpayers. A reliable and secure system of information returns and withholding regimes would support risk management. Not only could compliance control be based on information obtained from third parties, but the information could also be used by the tax administration to design a draft tax return that would initially be completed by the administration and sent to the taxpayer for confirmation, completion or modification. For the taxpayer, this could mean less effort in preparing his tax return, as most of the relevant data would already be available to the tax administration. A taxpayer could even fulfil his duty to file by approving the draft using "point-and-click". In addition, transparency could be enhanced if the draft tax return was accompanied by a draft tax calculation.

Interlinking the withholding of tax and the tax assessment adds dialogue to tax procedures. Taxation should be characterized by cooperation and not confrontation. Tax administrations pursuing a more cooperative approach towards taxpayers are anything but weak or naïve. On the contrary, such tax administrations realize and accept their factual limits regarding law enforcement and their dependency on the taxpayer's contribution and cooperation, for example, regard-

ing fact finding. A cooperative approach must, however, be backed up by sanctions and efficient examination and auditing methods, as nobody likes to pay taxes and few cooperate voluntarily.

In Germany, self-assessment is already applied with regard to VAT and taxpayers calculate, file and pay the tax due, taking over tasks that have traditionally been fulfilled "ex officio" by the tax administration. Tax assessments are issued preliminarily and obligatory audits are replaced by subsequent computer-aided and risk-based examinations. With regard to income and corporate income tax, similar methods are already applied, for example, in Spain, the United Kingdom and the United States.

In respect of such a reform in Germany, short filing deadlines would be necessary to guarantee that taxpayers could be assessed within reasonable time. As tax would be due on the filing of a tax return, the state's revenue would be protected and taxes could be collected earlier than under a system of assessment "ex officio". To improve compliance, taxpayers filing or paying late would have to be confronted with interest and civil penalties. A broad system of information returns would be necessary to guarantee that the tax administration had sufficient information for automatic data matching, i.e. checking information provided by taxpayers against information received from other sources. In addition, taxpayers would have to keep records not only for business income, but also for

all sources and types of income. Finally, to balance these additional obligations for taxpayers and the additional competences of the tax administration, the service provided by the administration would have to be improved and criminal penalties would be replaced, for the most part, by civil penalties so as to restrict penalization in the tax law.