Check the Box in Germany: Partnerships can opt for corporate income tax in the future

Germany's federal government agreed on a comprehensive financial aid package to stimulate and reinvigorate the economy on 3.6.2020. Part of it is an option model for partnerships. According to this model, the shareholders can decide that a partnership will be treated like a corporation for the purposes of income taxation.

1. Who can opt how?

The option is to be available for all partnerships that generate income from business operations. The option is exercised by the shareholders passing a resolution. Subsequently, the legal representatives have to file an application with the tax office.

2. Effects of the option

2.1 Scope of application

The resolution and the application to the tax office have the effect that the partnership is treated like a corporation for income tax purposes.Note: The option term of seven years must be taken into account; only after this period is a re-option for taxation like a partnership possible again.
tion like a partnership possible again.

2.2 Fictitious transformation of form

By exercising the option, the partnership is fictionally transformed into a corporation for income tax purposes. Shareholders are deemed to be granted shares in a corporation, as in the case of a change of legal form.

3. Current taxation after exercise of the option

3.1 Qualification and determination of income

After exercising the option, trade and corporate tax principles for corporations are to be applied. In accordance with the separation principle, the corporation and the shareholders now represent independent tax subjects each. Contractual relationships under the law of obligations (e.g. loan agreements) between the shareholder and the company are now recognized for tax purposes. This also applies to shareholder-manager contracts. The income is then no longer to be regarded as business income, but as income from employment. Social insurance obligation might arise.

3.2 Distributions of profits

In the case of "normal" corporations, profits generally remain in the company and are recognized as retained earnings in **equity**. Only when the shareholders explicitly decide to distribute all or part of the profit is capital gains tax (CGT) - a kind of withholding tax - to be paid and the net dividends paid out or credited to the shareholders' accounts.
In contrast, the reverse is true for partnerships even after exercising the option. The so-called full distribution principle still applies. This means that the company has to withdraw CGT on all taxed profits and the net dividend is credited to the **shareholder accounts**. If a retention or strengthening of equity capital is desired, there must be a provision under company law that profits are credited to a reserve account. Only in this case will no CGT be levied on the retained profits.

4. Exemplary comparison of tax burdens

The following assumptions are made:
- Partnership generates a taxable profit of 100,000 €.
- Trade tax 13.3%, corporate income tax (CIT) 15%, income tax with the marginal tax rate of 42% and CGT 25% are considered.
- Tax allowances, church tax and solidarity surcharge are not included in the calculations for reasons of simplification

A distinction is now made between three cases:

(1) Taxation without option: Partnership pays trade tax of 13,300 € on the profit, the shareholder account is credited with 86,700 €. Shareholders have taxable income of 100,000 €. Trade tax can be credited against the income tax of 42,000 €. So, shareholders pay 28,700 €.

Result: After taxes, shareholders have 58,000 € at their free disposal, the company has zero.

(2) Taxation with option without retention: The partnership owes 13,300 € trade tax and 15,000 € CIT. Of the remaining amount of 71,700 €, the company has to withdraw 17,925 € CGT. Shareholders have to tax 71,700 € as income from capital assets; the tax is fully covered by the creditable CGT.

Result: After taxes, 53,775 € remains at the free disposal of the shareholders, zero for the company.

(3) Taxation with option with retention: The partnership owes 13,300 € trade tax and 15,000 € CIT. 71,700 € can be added to the reserves.

Result: Insofar as taxed income is retained at the level of the partnership, it is not available to the shareholders. Only after a distribution has been resolved is CGT is to be withdrawn and taxation to be carried out at the level of the shareholders - which, however, is offset against CGT.

5. Conclusion

The example shows that the partnership does not necessarily have tax advantages if it opts for corporation tax. The advantage of the option model is that a "company" level is also formed and that, in the event of a retention, approx. 13,700 € less tax must initially be paid per 100,000 € of income and is available for internal financing. It remains to be seen how the option model will be specifically designed in the further legislative process.

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