YPOG Briefing: Revised Rules on the Taxation of Retained Earnings pursuant to Sec. 34a of the German Income Tax Act according to the Draft "Growth Opportunities Act" (*Wachstumschancengesetz*)

This briefing is part of our series of briefings on the various amendments of tax laws proposed by the German Federal Ministry of Finance this July. Today, we explain and discuss the proposal for a revision of the rules on the taxation of retained earnings pursuant to sec. 34a of the German Income Tax Act (GITA).

Global Minimum Tax Directive Implementation Act and Growth Opportunities Act

The German Federal Ministry of Finance has published two comprehensive draft bills in July, encompassing numerous new regulations and amendments to existing regulations relating to a wide range of tax matters. In a series of thematic briefings published throughout the coming days and weeks, we will outline the key contents of these draft regulations and provide insight into the opportunities and challenges they may pose to taxpayers.

The draft Global Minimum Tax Directive Implementation Act (*Mindestbesteuerungsrichtlinie-Umsetzungsgesetz*) contains regulations to implement the EU directive on global minimum taxation for multinational corporate groups, based on the proposals on Pillar 2 of the OECD's BEPS project. The draft also proposes changes to existing tax rules, particularly regarding German CFC taxation according to the Foreign Tax Act (*Außensteuergesetz*). The draft stipulates that a tax burden of less than 15% (instead of the current 25%) will be considered as low taxation. This change is in line with long-standing demands by practitioners and is likely to significantly impact the scope of application of the German CFC taxation rules.

The draft Growth Opportunities Act (*Wachstumschancengesetz*) includes numerous new regulations and amendments on various, largely unrelated, tax matters. For instance, it proposes the introduction of a climate protection investment premium, a cap on deductible interest rates for cross-border loans within corporate groups, and notification obligations for domestic tax arrangements. Further, the draft aims to expand the possibilities of loss carryback, revise the tax (procedural) treatment of partnerships, modify the rules for partnerships opting for tax treatment as corporations, and revise the taxation of retained earnings.

Revision of the taxation of retained earnings pursuant to Sec. 34a of the German Income Tax Act

The draft Growth Opportunities Act proposes amendments to sec. 34a GITA regarding taxation of retained earnings. The following summary provides an overview of the proposed changes and their implications for taxpayers.

1. Background

Sec. 34a GITA allows sole proprietors and partners of partnerships to claim a tax relief on profits if and for so long as the profits remain within the business. The goal of this regulation is to align the taxation of sole proprietorships and partnerships more closely with that of corporations and their shareholders and to promote the reinvestment of profits in the business.

Currently, such retained profits are initially taxed at only 28.25 % income tax plus solidarity surcharge if the taxpayer files a respective application. Only when the profit is later withdrawn from the business, additional income tax of 25% plus solidarity surcharge becomes due. This results in a total tax burden that is typically higher than if the profit were taxed immediately according to the general rules. The regulation therefore only results in a deferral of taxation, which may pay off (depending on the personal tax rate, trade tax rate, retention period and assumed interest rate) due to the interest effect.

However, the regulation is complex to apply and has rarely been used in practice due to various limitations of the tax benefits and restrictive requirements for its applicability.

2. Planned changes to sec. 34a GITA

From the 2025 assessment period, the Growth Opportunities Act aims to make the retained profits taxation regime more attractive through several changes. In particular, the proposed amendments to sec. 34a GITA aim to make the retained taxation more attractive for business owners who are not taxed at the highest marginal tax rate.

In order to strengthen the preferential effect, the retention volume is to be increased by withdrawals for tax payments as well as trade tax paid. For the purpose of administrative simplification, this should be possible without specific proof of use.

Furthermore, the rules on the order of use is to be improved. Tax-exempt and fully taxed profits retained in the company after 31 December 2023 may be withdrawn with priority. The new withdrawal volume can be built up and leads to a deferral of the subsequent taxation. The idea is that in this way entrepreneurs can facilitate the growth of their equity base while promoting economic growth.

In addition, according to the draft, the preferential treatment for reinvestment under sec. 34a GITA may in the future be taken into account already for the determination of advance tax payments by repealing sec. 37 para. 3 sentence 5 GITA.

3. Effects for taxpayers

The planned amendments to sec. 34a GITA as part of the Growth Opportunities Act represent an important development in corporate taxation.

However, in spite of the ministry’s express intention to improve the situation, the criticism of the current regulation that the subsequent taxation of non-withdrawn profits is subject to 25% income tax plus solidarity surcharge and thus the highest marginal tax rate is always applied, continues to be true after the proposed amendment. Therefore, we currently do not consider the proposed changes to create a significantly improved incentive to make use of the retained profits taxation. However, in view of the currently rising interest rates and associated opportunity costs, the regime could become more attractive for some entrepreneurs after an individual analysis.

In conclusion, while the legislator's intent is commendable, our initial assessment suggests that the effects may not be as significant as anticipated.

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