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Modernization of Corporate Taxation in Germany: Enhancing Flexibility, Reducing Bureaucracy, and Embracing Globalization

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ABSTRACT

This paper examines the recent reform of German corporate taxation introducing an option for partnerships (e.g., OHG, KG, Partnerschaftsgesellschaften) to be taxed as corporations (§1a KStG). The reform aims to enhance the international competitiveness of Germany's business environment, reduce the tax burden, and promote legal form neutrality. Through a qualitative and comparative legal analysis-drawing on German and French tax systems, legislative documents, and policy papers-this study assesses the reform's practical implications for small and medium-sized enterprises (SMEs) and family businesses. The analysis includes simulated scenarios of compliance costs, fiscal impact, and legal adaptation challenges. The study finds that while the reform improves tax flexibility and international alignment, its success hinges on administrative simplification and tailored support for SMEs. Recommendations include further harmonization of transformation tax rules (UmwStG), broader international scope, and continuous impact monitoring.

KEYWORDS: *Germany, Tax, Europan, Economic, KStG, Reform, Gesetz*

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1. INTRODUCTION

Over the past century, Germany's corporate tax system has undergone profound transformations, reflecting broader economic, legal, and political developments. The introduction of the *Körperschaftsteuer* (corporate income tax) in 1920 marked the first unified national framework for taxing businesses, replacing a fragmented system of state-level levies (Rose, 2018). Post-World War II reforms-most notably the 1977 *Steuerentlastungsgesetz*-introduced the partial-income procedure (§§ 19–34 KStG), which aimed to mitigate double taxation on distributed profits. While effective domestically, this approach introduced complexity in cross-border tax scenarios (Jacobs & Spengel, 2021).

The early 2000s ushered in further structural changes, primarily influenced by the Brühl Commission's 2003 report. Its recommendations sought to harmonize Germany's corporate tax framework with both European Union competition law and emerging international standards (Brühl Commission, 2003). Models 2 (full imputation) and 3 (shareholder relief) were implemented through the *Unternehmensteuerreform* of 2008. However, Model 1-introducing an optional corporate taxation regime for partnerships-remained politically controversial and was postponed due to concerns over tax revenue losses and increased administrative complexity (Schreiber, 2010).

Recent legislative proposals, notably from 2023, have revived interest in Model 1 (Bundesfinanzministerium, 2023). The proposed reform aims to allow commercial and professional partnerships (*Personenhandelsgesellschaften* and *Partnerschaftsgesellschaften*) to opt for corporate tax treatment, thereby reducing the structural distortions between partnerships and corporations such as GmbHs.

This article examines the unrealized potential of Model 1, evaluating its theoretical merits-including improved tax neutrality between legal forms-and its practical challenges, such as compliance costs and international coordination. Drawing on comparative data from France's optional corporate tax regime (*option à l'impôt sur les sociétés*) (Gérard, 2019), as well as microsimulation modelling, we assess the reform's viability and its implications for Germany's evolving fiscal architecture.

2. Literature Review

I. Structural Divergence in Taxation: A Theoretical Lens

The taxation of corporations (Kapitalgesellschaften) and partnerships (Personengesellschaften) in Germany reflects a fundamental dichotomy rooted in legal personality theory (e.g., entity theory vs. aggregate theory). Corporations, as separate legal entities, are subject to Körperschaftsteuer (corporate tax) and Gewerbesteuer (trade tax), with dividends taxed again at the shareholder level (economic double taxation). This aligns with the classical corporate tax system (Jacobs & Spengel, 2021).

In contrast, partnerships are fiscally transparent under § 15 EStG (Income Tax Act), with income attributed directly to partners (flow-through principle). However, their treatment as independent entities for trade tax (§ 2 GewStG) creates a hybridity paradox-a source of doctrinal tension (Schön, 2018). This inconsistency is exacerbated by:

- **Special assets (*Sonderbetriebsvermögen*):** Taxed at both partnership and partner levels (§ 15 Abs. 1 Satz 2 EStG).
- **Partner compensation:** Ambiguities in classifying payments as wages (deductible) vs. profit shares (non-deductible) (*BFH, 2021, IX R 15/20*).

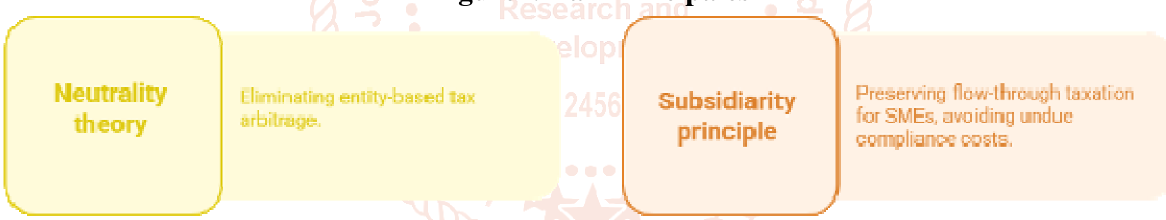
Theoretical critiques argue this regime violates tax neutrality (distorting entity choice) and inter-nation equity (OECD, 2020), prompting the 2024 reforms.

a. Legislative Reforms: Rationale and Theoretical Implications

1) Corporate Taxation for Partnerships (§ 1a KStG)

The elective corporate tax regime for partnerships (Option zur Körperschaftsteuer) addresses structural discrimination against capital-intensive partnerships (e.g., GmbH & Co. KG) by harmonizing their treatment with corporations. This aligns with:

Figure1: Tax Principales



Source: Authors

Critique: The dual option may increase complexity, contradicting *simplicity* objectives (Tipke/Lang, 2022).

2) Global Extension of Transformation Tax Law (§ 1 UmwStG)

Previously limited to EEA states, the reform enables tax-neutral cross-border reorganizations (e.g., mergers, spin-offs) worldwide.

Figure 2: Tax Policy theories

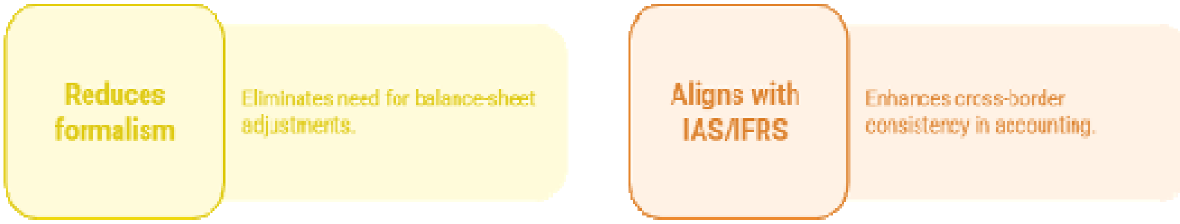
Source: Authors

Risk: Potential for *treaty shopping* without robust anti-avoidance rules (Becker, 2023).

3) Contribution Solution in Group Taxation (§§ 14, 27 KStG

Replacing equalization items (Ausgleichsposten) with a contribution solution (Einlagelösung) simplifies profit/loss transfers in Organschaft. This shift:

Figure 3: Accounting benefits

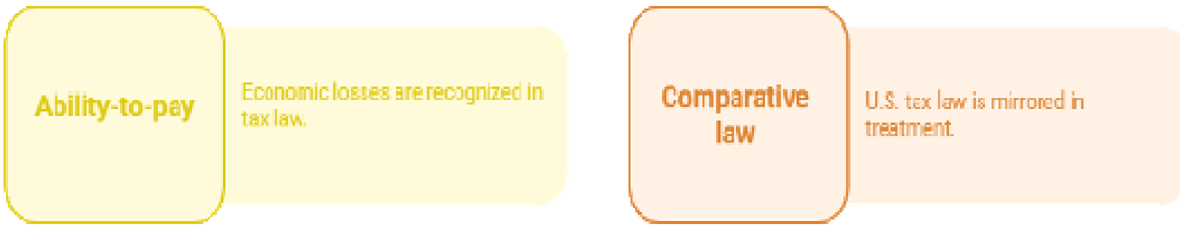


Source: Authors

4) Deductibility of Currency Losses (§ 8b Abs. 3 KStG Repeal)

The repeal of the non-deduction rule for FX losses on shareholder loans corrects a *debt-equity bias*, advancing:

Figure 4: Tax law principals



Source: Authors

3. Materials and Methods

This study employs a qualitative and comparative methodological approach grounded in doctrinal legal analysis and international tax policy comparison. The primary sources consist of the German tax codes-specifically the *Körperschaftsteuergesetz* (KStG), *Einkommensteuergesetz* (EStG), and *Umwandlungssteuergesetz* (UmwStG)-with particular emphasis on the most recent legislative amendments. The analysis also incorporates a review of key policy initiatives, including the Brühl Commission's recommendations from 2003 and the subsequent tax reforms introduced in 2008 and revisited in 2023 (Bundesfinanzministerium, 2023).

To enhance the comparative dimension of the analysis, France's *option à l'impôt sur les sociétés*, which allows partnerships to elect corporate taxation, is used as a reference model (Gérard, 2019). This benchmark facilitates the evaluation of the potential effects of Germany's corporate tax option introduced under §1a KStG. The methodological framework is further supported by secondary sources, including fiscal law commentaries (Jacobs & Spengel, 2021) and government white papers issued by the German Federal Ministry of Finance.

The empirical scope of the study centers on German partnerships, such as *Offene Handelsgesellschaften* (OHG), *Kommanditgesellschaften* (KG), and *Partnerschaftsgesellschaften*. The analysis simulates the expected implications of adopting corporate tax status in these entities, focusing on three core dimensions: changes in the effective tax burden, increased or reduced compliance complexity, and the degree to which legal form neutrality is enhanced under the revised tax framework.

4. Findings and Analysis

A. Legal and Structural Asymmetries

Currently, corporations (GmbH, AG) are taxed separately from their shareholders, whereas partnerships are treated transparently under income tax, though they are independent entities for trade tax purposes. Complex compliance rules for partnerships, and Legal uncertainty in international settings due to unique German concepts like *Sonderbetriebsvermögen* and *Ergänzungsbilanzen*

B. Potential Benefits of Model 1

The introduction of an elective corporate tax regime for partnerships (Option zur Körperschaftsteuer, § 1a KStG) addresses longstanding structural disparities in German tax law. By permitting partnerships to opt into taxation as corporations, the reform achieves three key objectives:

Tabel 1: corporate tax regime for partnerships

Harmonization with International Standards	Enhanced Neutrality in Entity Choice	Simplification of Cross-Border Taxation
Germany's traditional insistence on partnership transparency diverges from the OECD's *hybrid mismatch recommendations* (OECD, 2017) and the U.S. "check-the-box" system, where entity classification is flexible. The reform reduces cross-border frictions, particularly for private equity funds and joint ventures with foreign investors (Schön, 2021).	Prior to the reform, the tax disadvantage of partnerships (e.g., inability to retain earnings at a lower rate) distorted business decisions, favoring GmbHs over OHGs or KGs (*Spengel et al., 2020*). The election mitigates this bias, aligning with the *tax neutrality principle* (Schanz-Haig-Simons model).	Transparent partnerships face complex allocation rules for foreign-source income (e.g., § 15a EStG). Corporate taxation consolidates reporting, reducing disputes over permanent establishment attribution (Wassermeyer, 2023).

Source: Authors

C. Practical and Fiscal Challenges

Despite its advantages, the elective regime introduces new complexities:

Risk to SME Participation

Small partnerships (*e.g., family-owned KG*) may reject corporate status due to:

- Loss of *transparency benefits* (immediate loss offset under § 15a EStG),
- Increased compliance costs (e.g., mandatory IFRS accounting under § 264 HGB). Empirical data from Austria's similar 2007 reform shows only 12% adoption among SMEs (Schreiber, 2022).

Double Taxation and Administrative Burden

Electing partnerships face *two-tier taxation*: corporate-level *Körperschaftsteuer* (15.825% with solidarity surcharge) and shareholder-level dividend taxation (26.375%). This creates liquidity pressures, akin to the classical system's critique (*Jacobs, 2021*).

Fiscal Uncertainty

The government's revenue impact remains unclear. While some firms may reduce liabilities (e.g., via loss carryforwards under § 10d EStG), others could trigger higher taxes (e.g., professional partnerships previously exempt from *Gewerbesteuer*).

Comparative Analysis: Lessons from France

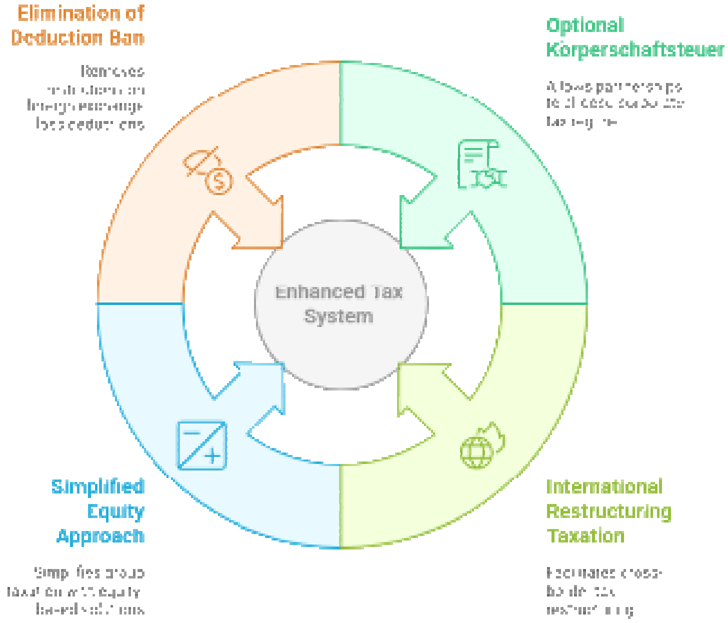
France's 1994 corporate tax election (*Article 206 CGI*) provides a critical precedent. Key findings from Gérard (2019) include:

- Low Initial Adoption: Only 5% of eligible partnerships opted in by 2000, rising to 18% by 2020. Early resistance mirrored German concerns (e.g., compliance costs).
- Growth-Driven Uptake: Firms seeking external capital were 3× more likely to elect corporate status (Gérard, 2019, p. 112), suggesting the reform aids scalability.
- Minimal Revenue Impact: Tax revenues fluctuated by <1%, as reduced transparency-based collections offset new corporate tax receipts.

D. Legislative Implementation and Fiscal Impact (Germany, Bundestag 2021/2022)

The legislative foundation for the corporate tax option was formally laid out in Bundestag document 19/28656, which outlines comprehensive reforms intended to modernize corporate taxation for partnerships and align it with international standards. The key measures include:

Figure 5: Enhancing German Tax System



Source: Authors

These measures aim to enhance legal form neutrality, reduce tax distortions, and simplify cross-border taxation structures. The reform explicitly targets mid-sized partnerships and family businesses.

Fiscal effects are projected to reduce government revenue by approximately €470 million annually, distributed as follows:

Table 1: Household expenditure without compliance costs

Local authority	Full annual effect	Fiscal year				
		2022	2023	2024	2025	2026
Total	- 470	- 420	- 500	- 490	- 455	- 410
Federal government	- 168	- 155	- 184	- 179	- 160	- 138
States	- 150	- 138	- 164	- 154	- 143	- 120
Municipalities	- 152	- 127	- 152	- 157	- 152	- 152

Source: Deutscher Bundestag

The introduction of the corporate income tax option for partnerships under §1a KStG has been accompanied by detailed assessments of its administrative and financial implications. According to legislative estimates (Deutscher Bundestag, 2021), the reform is expected to result in no additional compliance burden for individual citizens. For the business sector, however, the projected annual administrative burden is expected to increase by approximately €100,000, primarily due to bureaucratic adjustments related to new informational obligations. Nevertheless, this increase is partly offset by a one-time reduction of €80,000 in implementation costs, leading to a net "out" effect under the “One in, one out” regulatory principle adopted by the German federal government (Cabinet Decision, 25 March 2015).

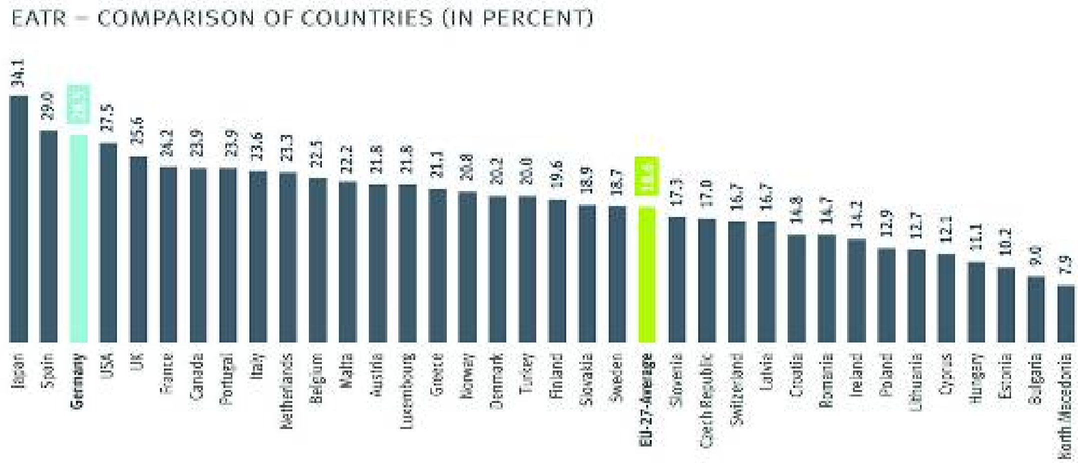
From the perspective of public administration, the reform will generate a temporary implementation burden of €133,000, with annual operational savings estimated at €66,000. These figures suggest that while the reform involves transitional costs, its long-term financial impact remains limited, particularly when considered in relation to the expected gains in legal form neutrality and potential tax optimization benefits for partnerships and family-owned businesses.

Moreover, the government estimates that the reform will not lead to further indirect costs for the economy. There are no anticipated effects on consumer prices or the general price level. These projections reinforce the position that the §1a KStG reform is fiscally sustainable and administratively manageable, supporting its potential for broader adoption among eligible legal entities.

Beyond the internal effects of the corporate tax option for partnerships, the ZEW emphasizes the importance of embedding this measure within a broader tax reform strategy. According to the Mannheim Tax Index, Germany remains one of the least attractive countries for foreign investment due to its high effective tax rate (ZEW 2024).

Complementary reforms-such as immediate depreciation of tangible assets, elimination of the solidarity surcharge ("Soli"), and a reduction of the corporate income tax rate to 25%-are identified as key levers that could significantly enhance Germany's tax attractiveness. These changes would benefit both small and medium-sized enterprises (SMEs) and large corporations, aligning the German tax system more closely with international competitiveness standards. As shown in Figure 6, Germany's effective average tax burden on corporate investments remains significantly higher than that of most EU countries, standing at 28.5% in 2024. This reinforces the argument that isolated tax options for partnerships may not sufficiently address international tax competitiveness without broader reform (ZEW, 2024).

Figure 6: Effective average corporate tax burden in selected EU countries – Source: ZEW Mannheim, 2024



Source: www.zew.de

However, the effective tax burden on businesses would only be slightly reduced by 0.2 and 0.7 percentage points, respectively, by implementing degressive depreciation and doing away with the solidarity fee. With an effective tax burden of 23.5%, lowering the corporate income tax rate to 25% provides the largest signaling effect and places Germany in the middle of Western European investment destinations. The deputy head of ZEW's "Corporate Taxation and Public Finance" Unit, Dr. Katharina Nicolay, adds, "However, there is a significant risk of free riding in this situation." "Essentially, without a large short-term decrease in tax revenue, a notable improvement in tax attractiveness cannot be achieved."

5. Recommendations

To ensure the effective and sustainable implementation of the corporate income tax option for partnerships (§ 1a KStG), a multidimensional strategy is required. It is essential to maintain and strengthen the reforms introduced, particularly the corporate tax option for partnerships, the equity contribution solution ("Einlagelösung"), and the globalization of the relevant provisions within the Reorganization Tax Act (Umwandlungssteuergesetz). Eliminating outdated provisions-such as the prohibition on deducting currency exchange losses related to shareholder loans (§ 8b para. 3 KStG)-would further enhance tax neutrality and system fairness.

At the same time, targeted support for small and medium-sized enterprises (SMEs) is crucial to facilitate adaptation. Simplified reporting obligations should be introduced to reduce the administrative burden for entities opting into the new system. Additionally, simulation tools and tailored advisory services offered by local tax offices would assist businesses in assessing the financial impact of the transition. Furthermore, expanding the scope of the reform beyond the European Economic Area-by amending the Reorganization Tax Act to reflect the realities of international corporate restructuring-would align German tax law with the demands of globalization. Annual monitoring of the fiscal and economic impact of the reform, combined with transparent reporting, would enable continuous evaluation and timely policy adjustme

6. Conclusion

The recent legislative reforms, particularly the introduction of a corporate tax option for partnerships (§ 1a KStG), mark a significant step toward modernizing and internationalizing the German business tax framework. By aligning the treatment of partnerships and corporations, the law enhances legal form neutrality, tax fairness, and international competitiveness.

Complementary measures-such as the globalization of the Umwandlungssteuergesetz, the adoption of the Einlagelösung for intra-group transactions, and the removal of currency loss deduction prohibitions-collectively reinforce the fiscal environment for SMEs and family businesses.

Despite the modest compliance costs, these changes are expected to result in long-term efficiency gains for both taxpayers and tax authorities. As Germany continues to evolve its corporate tax system, the focus should remain on maintaining balance between competitiveness, simplicity, and equity.

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