



Reform of VAT in Germany? The new 21–10–0 formula

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1 Background

According to consistent reports, the leaders of the governing coalition have agreed on a fundamental reform of VAT. The “21–10–0 formula” is intended to significantly alter the current system of VAT rates. The objective of the reform is to generate additional government revenue whilst, at the same time, providing social relief through a zero VAT rate on foodstuff. The measure would have considerable fiscal, systemic and practical implications and ranks among the most far-reaching changes to VAT legislation in recent decades. According to current plans, the reform is set to enter into force on 1 January 2027.

2 Comprehensive changes to VAT rates

At the heart of the reform is the increase in the standard VAT rate from the current 19% to 21%. At the same time, the reduced VAT rate is set to rise from 7% to 10%. In return, it is planned that supplies of foodstuff will, in future, be taxed at a rate of 0%. According to calculations, the additional revenue from the increase in the standard VAT rate is expected to amount to around 30 billion euros annually, whilst the increase in the reduced VAT rate is expected to generate a further three billion euros or so. This is offset by a loss of tax revenue of around 17 billion euros resulting from the application of the zero VAT rate to foodstuff. Overall, this would result in additional annual revenue of around 16 billion euros (which is intended to finance income tax relief).

Of particular significance, from a VAT law perspective, is the introduction of a further zero VAT rate: following the introduction of the zero VAT rate for certain supplies of photovoltaic systems, Germany would, once again, be making use of the option



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provided for under Union law. This is because Art. 98 para. 2 of the EU VAT Directive, in conjunction with Annex III, allows Member States to apply a 0% VAT rate to certain supplies of goods and services. This includes foodstuffs, including beverages, with the exception of alcoholic beverages. Union law permits differentiation in this regard, for example based on staple foods or social policy criteria.

It remains to be seen how broadly the German legislator intends to define the scope of the zero VAT rate in relation to foodstuff. From a VAT perspective, it is important to note that the zero VAT rate does not constitute a VAT exemption. Supplies subject to the 0% VAT rate entitle the supplier to input VAT deduction. The entitlement to input VAT deduction is thus preserved, while VAT is not charged on transactions relating to inputs.

3 Consequences for the practice

In practice, the reform will give rise to considerable challenges. The main risk lies in the possibility of the incorrect application of the zero VAT rate. If the 0% VAT rate is applied incorrectly, a risk of retrospective taxation, at the future standard VAT rate of 21%, will exist. Interest may also be payable under sec. 233a of the German Fiscal Code. The financial implications of an incorrect assessment are considerable. For all other supplies too, the incorrect assumption of a VAT exemption will result in costs that are 2 percentage points higher.

Furthermore, it is foreseeable that numerous delimitation questions will arise. This applies, in particular, to composite products, processed goods or mixed supplies. It is already evident today that the delimitation between different VAT rates is one of the most practically significant and contentious issues in VAT law. Popular examples here include white coffee, latte macchiato, etc. The introduction of an additional zero VAT rate is likely to further exacerbate this issue. The only beneficiaries will be tax advisers, owing to unnecessary delineation issues. That said, such a 'stimulus programme' is not required, and addressing these questions hardly amounts to a rewarding exercise.

It also remains to be seen to what extent the VAT relief on foodstuff will actually reach end consumers. A full pass-through of the VAT cut requires functioning competition. At best, prices could theoretically fall by around 6.5%. However, experience with previous VAT cuts shows that relief is often only partially passed on or is eroded by price and margin adjustments along the supply chain. For many households, the relief from the zero VAT rate on foodstuff is likely to be offset by the simultaneous increase in the standard and reduced VAT rates. Ultimately, consumption would be taxed at a higher rate overall. Low-income households would be particularly affected by this.

From a business perspective, the disadvantages therefore carry significant weight: additional legal uncertainty, rising risks in determining VAT rates and a further complication of VAT, will all act to undermine planning security and competitiveness. Shifting the tax burden onto consumption is highly risky from an economic policy perspective. It would be better to generate higher tax revenues through higher corporate profits. But to achieve this, Germany urgently needs the long-awaited 'autumn of reforms' as announced by Chancellor Friedrich Merz last year: with genuine structural reforms in social, tax and economic policy, and sustainable fiscal discipline on the part of the state.