

Corporate Taxation of Dividends: A Comparison between the Japanese and the German System

Miyuki Ueda *

- I. Introduction
- II. The Japanese System
 - 1. Background
 - 2. New Rules
- III. The German System
 - 1. Background
 - 2. Current Rules
- IV. Some Observations

I. INTRODUCTION

International double taxation arises in cross-border investments because income arising from such investments is normally taxed not only in a country of source, but also in the country of residence of the recipient. In order to relieve double taxation, some countries operate a credit system, while others operate an exemption system. Under a credit system, domestic parent companies are taxed on their worldwide income, including dividends (gross of foreign taxes) received from their foreign subsidiaries, but the parent companies are allowed to credit foreign taxes against their domestic tax liabilities. Under an exemption system, dividends received from foreign subsidiaries are simply exempt from taxable income of domestic parent companies, and thus profits earned by foreign subsidiaries are only taxed in their foreign source country.

Japan so far has operated a credit system, but partially replaced the credit system with an exemption system under the 2009 Tax Reform (hereinafter the Reform).¹ After the Reform, 95% of qualifying foreign dividends is treated as non-taxable income for Japanese corporation tax purposes. Such treatment appears similar to that of Germany at first glance, but there exists a fundamental difference in the conceptual basis because each country has differing tax policies affected by their individual tax history, philosophies, political situation, and geographical location. This article discusses the national corporate taxation of dividends in both countries, focusing due to the space limitation solely on the double taxation relief system.

* My special appreciation goes to Michael H. Shikuma of the Tokyo office of White & Case LLP, and Takeo Mizutani of White & Case International Tax Office, who have provided valuable information and comments for this article.

1 *Shotoku-zei hô tô no ichibu o kaisei suru hôritsu*, Law No. 13/2009.

II. THE JAPANESE SYSTEM

1. Background

Japan introduced a foreign tax credit (FTC) system in 1953. The scope of the FTC system, limited at the beginning, was significantly expanded in the early 1960s (for example, the introduction of an indirect FTC and the carry-over of excess credits and excess foreign taxes, switched from a credit-by-source method to a worldwide credit method) corresponding to the rapid growth of Japan's export businesses.² Since the late 1980s, however, the limitation on FTCs has been tightened in response to some cases³ of aggressive use of FTCs. The revisions over the years have made the FTC system complicated and have increased compliance costs.

Prior to the Reform, dividends received from foreign subsidiaries by Japanese parent companies were subject to taxation in Japan, and the Japanese parent was generally allowed to credit foreign income taxes against their domestic tax liabilities under Art. 69 (1) and (8) of the Corporation Tax Act (hereinafter the CTA).⁴ The FTC was available, subject to the limitation of the Japanese tax attributable to foreign source income, not only for foreign withholding taxes on the dividends assessed directly on the Japanese parent (direct FTC), but also for the underlying corporate level income taxes paid by their direct foreign subsidiaries (indirect FTC), provided that the Japanese parent held 25% or more of the total issued shares of the foreign subsidiaries for at least six months before the dividend distribution (Ownership Test; Art. 69 (8) CTA and Art. 146 CTA Enforcement Order⁵ (hereinafter CTA EO)). The indirect FTC was extended to second-tier subsidiaries in 1992.

Generally, profits of foreign subsidiaries are taxed in Japan (at approx. 42% combined corporate tax rate) only when they are remitted to the Japanese parent as dividends (Art. 22 (2) CTA). Accordingly, there exists an incentive for Japan-based multinationals to keep foreign profits offshore by deferring distributions, where such foreign subsidiaries are subject to a local income tax of less than 42%. As with many countries, Japan has anti-deferral (Anti-Tax Haven) rules as a countermeasure against abusive schemes to defer tax on foreign profits, under which the undistributed profits of a "specified foreign subsidiary"⁶ allocable to a Japanese parent are subject to current taxation in Japan

2 See, e.g., Y. MASUI, International Taxation in Japan, A Historical Overview, Tax Notes International 2000, 2818.

3 As one of the most recent reported cases, see, Supreme Court, 19 December 2006, *Hanrei Jihô* 1918 (2007) 3.

4 *Hôjin-zei hô*, Law No. 34/1965, as amended by Law No. 23/2008 (last amendment by Law No. 13/2009). Art 69 (1) was revised and Art. 69 (8) was repealed under the Reform.

5 *Hôjin-zei hô sekô-rei*, No. 97/1965 (last amendment by Ordinance No. 166/2009).

6 A "specified foreign subsidiary" is defined as a foreign company incorporated in a country in which the corporate tax burden is 0% or the income is subject to an effective corporate tax of 25% or less; (2) does not conduct an active trade or business in its country of its incorporation or its main office; and (3) in which Japanese resident companies and individuals hold directly or through attribution more than 50% of the shares.

(Art. 66-6, Special Taxation Measures Law⁷). However, there exist many cases in which profits of foreign subsidiaries have legitimately been retained abroad due to the uncompetitive effects of the relatively high Japanese corporation tax burden and administrative costs and limitations in claiming FTC in Japan. The additional tax burden and complexity of the FTC system may have distorted decisions on profit repatriation by Japan-based multinationals and have a negative impact on financing of R&D activities and/or workforce in Japan.⁸ In order to reduce the administrative complexity of the FTC system and to increase the tax neutrality of profit repatriation, the Reform abolished the indirect FTC system⁹ and, in its place, a foreign dividend exemption system has been introduced.¹⁰

2. *New Rules*

For fiscal years starting on or after April 1, 2009, a Japanese parent company may deduct 95% of dividends received from a foreign subsidiary as non-taxable income for corporation tax purposes (*ekikin fu-sannyû*), provided that the above Ownership Test¹¹ is satisfied.¹² As a result, no international double taxation arises, and thus no direct or indirect FTC is allowed. The non-deductible 5% of dividends remains taxable because such amount is deemed to represent the amount of the Japanese parent's expenses allocable to the exempt foreign dividends. Thus, "double non-taxation" (a deduction for foreign dividends and a deduction of the parent's expenses incurred in generating such non-taxed dividend income) may be avoided. The new foreign-dividends *ekikin fu-sannyû* rules apply only to Japanese companies, but not to Japan branches of foreign companies as in the case of the FTC, which is only available to Japanese companies.¹³

Since dividends are paid out of after-tax profits, technically double taxation of dividends arises not only internationally, but also domestically. The Japanese CTA provides for an *ekikin fu-sannyû* measure to avoid such domestic double taxation. Broadly speaking, dividends received by a corporate shareholder from its Japanese subsidiary are excluded from taxable income, provided that 25% or more of the total issued shares of the

7 *Sozei tokubetsu sochi-hô*, Law No. 26/1957, as amended by Law No.61/2009

8 Concerns expressed by the Ministry of Economy, Trade, and Industry of Japan, *see*, <http://www.cao.go.jp/zeicho/siryou/pdf/k27kai27-3-1.pdf>

9 Complete repeal is anticipated after a transitional period.

10 The taxation and direct FTC on dividends paid by a foreign company, which does not satisfy the Ownership Test, as well as the taxation and direct FTC system of foreign interest and royalties earned by a foreign branch of a Japanese company, remain unchanged.

11 The required shareholding ratio and/or period may be reduced, depending on applicable tax treaties (Art. 22-3(4) CTA EO).

12 Art. 23-2 CTA.

13 Art. 142 CTA. For the reason of exclusion of Japan branches of foreign companies from the FTC system, *see, e.g.*, T. MIZUNO, *Sozei-hô* (Theory of Tax Law in Japan), 4th edition (Tokyo 2009) 531.

subsidiary are held.¹⁴ If the parent has incurred interest expense, then a portion of such interest expenses, allocated based on the ratio of the value of the subsidiary stock against the value of the total assets, is not deductible.¹⁵ In the case of dividends received from domestic companies other than $\geq 25\%$ owned subsidiaries, the amount of deductible dividends and the amount of non-deductible interest expenses allocated thereto, are reduced by 50%. The domestic-dividends *ekikin fu-sannyû* rules apply to Japan branches of foreign companies.¹⁶

III. THE GERMAN SYSTEM

1. Background¹⁷

From 1977 until 2000, Germany implemented the so-called *Vollanrechnungsverfahren*, the imputation system combining a split rate structure with a full credit on distributions for corporation tax. A portion of corporate profits distributed as dividends was taxed at 36%,¹⁸ while the retained portion was taxed at 56%.¹⁹ Dividends carrying the imputation credit (equivalent to the 36% corporation tax paid) were subject to taxation at the tax rate applicable to each of the recipients, who were able to fully take the imputation credit against their own tax liabilities.²⁰ In so doing, double taxation of dividends was avoided between dividend-distributing companies and their individual and/or corporate shareholders. German corporation tax and individual income tax were fully integrated, *i.e.*, a distributed portion of company profits was taxed only once at the rate of an ultimate individual shareholder, irrespective of the number of corporate shareholders in between. The imputation credit was given only to German resident companies and individuals. In other words, the imputation system was used only for the elimination of double taxation of domestic dividends. For foreign dividends received by German resident companies, double taxation was mitigated originally through FTC (subject to limitations) under the German domestic corporation tax law. Indirect FTC was given for underlying corporation taxes paid by foreign subsidiaries, provided that the German parent held 25% or more of the stated capital of the foreign subsidiary for at least 12 months before the relevant balance sheet date.²¹ The indirect FTC was also allowed for foreign income taxes on second-tier subsidiaries.²²

14 Art. 23(1)(2)(5) CTA. Six-month holding is not required.

15 Art. 23(4) CTA.

16 Art. 142 CTA.

17 For the 1977 Reform, *see, e.g.*, H. AULT / A. RÄDLER, *The German Corporation Tax Reform Law 1977* (Deventer 1976); and for the 2001 Reform, *see, e.g.*, M. DESENS, *Das Halbeinkünfteverfahren* (München 2001).

18 Later reduced to 30% (1994-2000).

19 Later reduced to 50% (1990-1993), 45% (1994-1998), 40% (1999-2000).

20 Excess credit was refunded.

21 § 26 Abs.2 *Körperschaftsteuergesetz* 1977 (KStG; German corporation tax law of 1977).

22 § 26 Abs.5 KStG 1977.

In order to ensure that dividends were taxed at 36%, German resident companies were required to keep records of net equity available for dividend distributions, divided into portions according to the tax burdens already borne by each portion. So long as dividends were out of the portion already subject to German corporation tax at 56% in prior years, the difference of 20% (56-36%) tax was decreased upon distribution. Alternatively, if dividends were deemed to be paid out of the portion which was not taxed in Germany, the German corporation tax at 36% became due upon distribution. Under the original imputation system, foreign dividends were not taxed upon receipt by German resident companies at the first tier, through FTC or in most cases due to the exemption under the tax treaties concluded by Germany, but were subject to corporation tax at 36% upon distribution as dividends up to their parent companies. Such imposition of German tax was regarded as a financial obstacle by German conglomerates. Thus, the exemption system was added as § 8b Abs. 1 Körperschaftsteuergesetz (KStG) in 1994. Subsequently, dividends distributed between German companies out of exempt foreign source income (including exempt foreign dividends) became no longer subject to German corporation tax. Such dividends were passed on to the ultimate individual shareholders, without being subject to German taxation (thus carrying no imputation credit) and simply taxed at the progressive individual income tax rate. This provision was added as a preferential tax treatment based on the political decision²³ to make Germany a more attractive location for holding companies and to support German-based multinational enterprises in global competition.²⁴

The imputation system was an ideal integration method in a closed economy. However, due to its extreme complexity, vulnerability to abusive structures, and particularly incompatibility with EU laws,²⁵ the German legislature in 2001 switched from the imputation system to a shareholder-relief system, *Halbeinkünfteverfahren*.²⁶ Under the reform 2001, corporate profits became taxable at 25%,²⁷ irrespective of retention or distribution, and only a half of the dividends became taxable in the hands of individual shareholders.²⁸ In this way, double taxation between individuals and companies would

23 J. ZIMMERMANN, § 8b Rz. 3 in: Erle/Sauter (Hrsg.), Heidelberg Kommentar zum KStG (2. Aufl. Heidelberg 2003).

24 D. GOSCH, § 8b Rz. 1, in: Gosch (Hrsg.), Körperschaftsteuergesetz: KStG (2. Aufl. München 2009); H.-J. WATERMEYER, § 8b KStG, Anm. 12, in: Herrmann/Heuer/Raupach (Hrsg.), Kommentar zum EStG und KStG (Lfg. 215, Köln, Juli 2004).

25 BMF (Hrsg.): Brühler Empfehlungen zur Reform der Unternehmensbesteuerung: Bericht der Kommission zur Reform der Unternehmensbesteuerung, BMF Schriftenreihe Heft 66 (Bonn 1999) 45-48.

26 Up to 2019, transitional measures are provided. *Halbeinkünfteverfahren* is currently called *Teileinkünfteverfahren*, as the exempted percentage of dividends has been reduced to 40% in 2009. Since 2009, individual income taxation of dividends on *Privatvermögen* has been settled through withholding tax.

27 Currently 15%.

28 Highest individual income tax rate in 2001 was 48.5%.

generally be alleviated in a very simple manner. Upon introduction of the *Halbeinkünfteverfahren*, the provisions of § 8b KStG were completely revised and its meaning changed fundamentally. The current § 8b KStG represents a normative structure to relieve double taxation between distributing companies and their corporate shareholders which arises regardless of whether dividends are “foreign” or “domestic” and whether the corporate shareholders are “foreign” or “domestic.”

2. *Current Rules*

95% of dividends received by corporate shareholders²⁹ in Germany are exempt from German corporation tax.³⁰ 5% of the dividend income remains taxable as being deemed as a non-deductible expense relating to the holding and management of the investment. There is neither a minimum shareholding ratio nor a minimum holding period required for such exemption. The dividends exemption rules apply to dividends paid not only by German companies, but also by foreign companies. The corporate shareholders here are not limited to German companies, but include German branches of foreign companies.

Such completely equal treatment of foreign dividends and domestic dividends, and non-discrimination between German branches of foreign companies and German companies for the purpose of relieving double taxation, did not exist from the outset. The provisions of § 8b KStG were amended several times, gradually eliminating the discriminatory provisions.³¹ As an EU member state, Germany faces constant pressures from the European Court of Justice, which is gaining increasing influence through jurisprudence even in the area of direct taxation. Germany must comply with the EU Treaty, which prescribes that national tax laws may not allow discrimination between nationals of different EU member states, and they may not violate the fundamental freedoms of the Internal Market, *i.e.*, free movement of goods, services, capital and persons, as well as freedom of establishment.

IV. SOME OBSERVATIONS

95% of foreign dividends are excluded from taxable income for Japanese corporation tax purposes, where the Ownership Test is satisfied. 95% of foreign dividends are not subject to German corporation tax as well, but unconditionally. The current German system is very simple and straightforward, *i.e.*, where double taxation arises, it must be relieved, irrespective of the residence of the recipient and the payor, and irrespective of the shareholding ratio and holding period. On the other hand, double taxation of domestic dividends has been treated as a separate issue from international double taxation of

29 Except for financial institutions (§ 8b Abs. 7 KStG).

30 § 8b Abs. 1 Satz 1, Abs. 5 KStG.

31 For example, non-deductible expenses were determined differently up to 2003.

foreign dividends in Japan,³² because relief of the latter is a type of concession of Japanese tax sovereignty vis-à-vis foreign governments. Thus, double tax relief for domestic dividends and foreign dividends are provided under different conditions in Japan. Moreover, Japan grants no relief for double taxation arising from portfolio investments in foreign countries. In sum, the current German system is more open-economy oriented than the Japanese system even after the Reform, which is intended to preserve the Japanese tax base more effectively.

ZUSAMMENFASSUNG

Das Einkommen einer Körperschaft unterliegt bei ihr selbst der Körperschaftsteuer, die von ihr an ihre Anteilseigner ausgeschütteten Gewinne werden ebenfalls der Besteuerung unterworfen. Daher entsteht die sog. internationale körperschaftsteuerliche Doppelbesteuerung, wenn eine Körperschaft ihre Tochtergesellschaft im Ausland hat. Bisher entlastete Japan von einer solchen internationalen körperschaftsteuerlichen Doppelbesteuerung durch die Anrechnungsmethode, im Rahmen der Unternehmenssteuerreform 2009 wurde nunmehr aber ein Freistellungssystem eingeführt. Der Aufsatz vergleicht die unterschiedlichen Methoden der Entlastung von internationaler körperschaftsteuerlicher Doppelbesteuerung im Falle von Dividenden in Japan und Deutschland. Dabei werden die unterschiedliche Steuerpolitik und die jeweilige geschichtliche Entwicklungen in den beiden Staaten diskutiert.

32 T. MIZUNO (*supra* note 13) 385, 569.