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Haskins & Sells

Corporation Taxation in Germany—1977

The New System and Its Implications for Nonresident Shareholders

APR 11 1977

Introduction

Effective January 1, 1977 the corporation tax system in Germany has been substantially amended and reformed. Germany has joined a growing list of developed countries that have adopted an imputation-type system under which all or part of the corporation tax is imputed to corporate shareholders when earnings are distributed and is allowed to such shareholders as a credit against their own income tax. The new system is described in this booklet together with some comments on the potential impact of the new system on non-German and more specifically on U.S. shareholders.

The material included in this booklet is based upon a memorandum describing the new system which was prepared by Mr. Rudolf J. Niehus of the Deloitte, Haskins & Sells Düsseldorf office. The Haskins & Sells International Tax Department collaborated in its preparation.

This booklet is not intended as a supplement to the existing booklet "Taxation in Germany," which is a part of the series constituting the Haskins & Sells *International Tax and Business Service*. That booklet is in the process of being updated and will be supplemented or revised in due course.

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Corporation Taxation in Germany—1977

In his address to the West German Bundestag on May 17, 1974 the then newly elected Chancellor identified reform of the system of corporation tax as one of the prime objectives of his government. He vowed that the reform would become law in 1977. The new law was published in the *Federal Gazette* on August 31, 1976. It is applicable for all fiscal years ending on or after January 1, 1977.

Old and New Systems Compared

Till now, Germany has levied a separate income tax on corporations and then another tax on shareholders when corporate profits were distributed as a dividend. The standard corporation tax rate (including the supplemental tax) was 52.53 percent of taxable income, but in the case of distributed profits it was reduced to 15.45 percent. Inasmuch as the corporation income tax itself is not a deductible item, the so-called shadow effect (i.e., tax on tax) brought the minimum tax rate up to 24.56 percent. The result was that the tax rate for distributed profits was less than half of that for profits retained.

Although such tax rates may be considered favorable in comparison with those of many other countries, the fact that the profits of a corporation were effectively taxed twice, namely at the corporate level and subsequently in the hands of the stockholder, has been considered an inequity in Germany since this tax was introduced in 1919.

The new system completely eliminates the double taxation of corporate profits. This is accomplished by allowing for a credit against the tax levied on dividend income at the shareholder level for the tax levied on the corporation on the profit distributed to stockholders. This means that effectively the profits distributed by a corporation in the future will be taxed only once.

Comparison of tax rates

One of the more important consequences of the new law is the overall increase in the tax rates for corporations as such. The following simplified comparison may serve as an illustration:

	Old System	*New System*
1. Tax rate on profits retained	52.53%	56.00%
2. Tax burden		
Profit before tax	DM100.00	DM100.00
Less tax	52.53	56.00
	DM 47.47	DM 44.00
Tax burden in respect of profits retained	110.66%	127.27%
		or 56/44
		i.e. 14/11
3. Tax rate on profits distributed	24.56%	36.00%
4. Tax burden		
Profit before tax	DM100.00	DM100.00
Tax	24.56	36.00
	DM 75.44	DM 64.00
Tax burden in respect of profits distributed	32.56%	56.25%
		or 36/64
		i.e. 9/16

Inasmuch as no company normally will be in a position to distribute all of its profits, the increase in the tax burden on profits retained from 110.66 to 127.27 percent or by 16 percent is particularly significant. Also, the tax burden on profits distributed shows a sharp increase. However, at least as far as resident taxpayers are concerned, this is a fictitious increase, because the 36 percent is fully available as a credit against their personal income tax, or as a refund if their overall tax burden is lower.

The fractions 14/11, which is the "standard tax burden" *(Tarifbelastung)*, and 9/16, being the "profit-distribution burden" (*Ausschüttungsbelastung*, i.e., the tax on equity distributed as profits), are of key importance for an understanding of the mechanism of the new system. It is likely that these terms will become catchwords of German taxation. They are used in the following discussion.

Some reasons for the change

It becomes evident from the government report that accompanied the bill that the change in German corporate income taxation was made primarily for three reasons:

1. There is often a divergency of interests between one (or several) majority stockholder(s) on the one side and the many private stockholders on the other. The latter want to see cash, whereas institutional investors in many cases prefer a retention of the corporate profits, at least for a transitory period. One of the many causes for these opposite views has been the impact of the double taxation of corporate profits on the net-income position of the respective stockholders.

2. In the past in Germany, the legal form through which a business operates has been greatly influenced by tax considerations, often not to the best advantage of the business as such. In the future, the net income tax burden on a corporation will effectively equal that on other forms, for instance, on a partnership owned by resident individuals. This means that in the future the choice of the form of organization of a business will be motivated by tax considerations to a lesser degree than at present.

3. Under the old system, equity capital has been very expensive because the dividend that it generates is burdened with tax, whereas interest expense on loan capital is usually distributed tax free. One of the wholesome effects of the new system probably will be the reduction of the tax burden on equity capital. It is generally expected that, for this reason, management will often find it more advantageous to issue new stock than to borrow money.

In light of these reasons for changing the corporate income tax and the fact that under the new system the total corporate income tax will be available as a credit at the stockholder level, it is logical to ask "Why not abolish this tax altogether?" The concept of the new law, however, does not bear this out. The corporate income tax has not been conceived as a prepayment of the income tax proper, as is the case, for instance, with the value-added tax. If a profit is distributed, the corporate income tax is eliminated only where the stockholder is subject to taxation in Germany in respect of the dividend he has received. Only in this case does the law provide for a tax credit. This will explain why nonresident stockholders suffer under the new system. In fact, they would seem to be penalized, as is more fully discussed below.

In the context of an overview, it might be noted that the 36-percent rate applicable to distributed profits, as such, has no real significance. It would have been feasible to grant the stockholder a credit for the whole of the 56-percent standard tax burden and thus to eliminate the dual rate altogether. For the following reasons it was decided not to grant a full tax credit:

1. Significant tax credits (or cash rebates) to recipients of dividends who do not fall into the highest tax bracket, because they have managed to "tax-protect" their otherwise substantial income, would have been unwise for political reasons.

2. Denying a tax credit to nonresident shareholders while levying a corporate income tax of 56 percent would have led to protests by foreign countries and would have unnecessarily strained relations with them.

3. As long as there is a difference of not more than twenty percentage points between the rate on profits distributed and that on profits retained, Germany does not have to lower the rate of the dividend withholding tax.

The New System

General structure

The new system has three main features:

1. There will be a uniform tax rate of 56 percent. It is called the standard tax burden *(Tarifbelastung)* by the law. The many different rates which made the old system so complicated will be abolished. Reduced tax rates will be available in the future, except for businesses established in Berlin, only for certain credit institutions which under the present system already enjoyed such preferential treatment, for associations, and also for the profits of a branch of a nonresident entity. In the last case, the tax rate will be 50 percent, down by about 0.5 percent from the present rate.

2. If profits are distributed, the corporate tax burden regularly will be 36 percent. In a normal case, this means that the tax burden on profits is reduced from 56 percent to 36 percent. However, as the credit will be claimed even where tax-exempt earnings are distributed, it is necessary to burden such profits prior to distribution with corporation income tax.

The new system creates a completely new administrative procedure for millions of taxpayers, involving the application of the profit-distribution burden against their personal income tax. It was felt that this procedure could be administered by the corporations and by the fiscal authorities only if it was made as simple as possible—specifically, if the amount available as a credit is always the same fraction of the cash dividend received. This theorem is expressly stipulated in the law. The available credit is always 36/64, or 9/16, of the cash dividend.

If management believes that the shareholders should enjoy the same net amount of dividend income under the new system as under the old, this may have the consequence of reducing the cash dividend so that the shareholders rather than the distributing corporation ultimately are burdened by the increase in corporate income tax.

3. In respect of that portion of the profit used for a dividend distribution, an absolute reduction of the tax rate to 36 percent is made. In other words, not only is the amount distributed subject to the 36-percent tax, but the total of the profit used both for the tax and for the dividend distribution is so subject. Thus, the shadow effect, so well known from the old law, will disappear. The full 36 percent is available as a credit to the taxpayer, either by way of a reduction of his personal income tax or in the form of a cash refund.

Feasibility and administration

The German fiscal authorities have tried out the feasibility of the new system in "operation games" conducted with several German credit institutions and industrial corporations. Apparently, no insurmountable obstacles were encountered.

The new system provides that all those shareholders who are not assessed to personal income taxation (for instance, the millions of employees who earn a salary from which a withholding is made, but who have no other taxable income) will in the future receive the cash dividend together with the tax credit in cash.

It can easily be imagined that by this provision a major part of the work of the German tax administration is shifted to the German credit institutions. In any event, in order to receive part or all of the credit in cash from the bank, the taxpayer will first have to inform the bank of his tax status. Many taxpayers who are also creditors of a bank may not like this, for obvious reasons.

Concept of taxable income unchanged

The new law basically does not change the nature and the definition of the income taxable to corporations. As in the past, the corporation income tax law refers to the definition of the taxable income contained in the income tax law for individuals. Taxable income generally may be defined as all profits generated from all commercial or industrial activities of the enterprise.

For all practical purposes, the category of expenses that are deductible for general accounting purposes has not been changed. As in the past, net-assets tax *(Vermögensteuer)* and gifts to business friends (if in excess of DM50, in each individual case for a year), to name the more important ones, are not deductible.

There is a change, however, that relates to the compensation paid to board members *(Aufsichtsratvergütung).* In the future this will be of some importance, because under the new labor codetermination law a great number of companies either will have to install such a board or will have to enlarge it. In a change from the past, the compensation paid to board members in the future will be tax-deductible at 50 percent. Overall, however, the effect of the new system on nondeductibles will be felt in the higher tax burden in respect of profits retained, since these expenses are charged against fully taxed income.

As under the old system, losses may be deducted from taxable income and, to the extent of any excess, carried forward for five years. The new system makes special provision for the application of such losses against equity that has not been burdened with tax, as is discussed in more detail below.

How the New Law Works

It should be evident from the foregoing that, in the future, corporate income taxation will, in addition to involving the determination of the standard tax burden, consist of two additional procedures under which this burden is relieved:

1. Establishing the profit-distribution burden at 36 percent on the profit distributed, since only this much will be available as a credit on the stockholder level

2. Application of the 36 percent against the total tax payable by the shareholder

Establishing the 36-percent profit-distribution burden

As far as establishing the profit-distribution burden is concerned, it must be emphasized again that it is the clear intention of the new law that in the future the tax burden will be exactly 36 percent. In order truly to avoid the double taxation of corporate profits, it must be assured that the sum of the amount declared as distributable profit and the amount of corporate income tax available for a credit on the shareholder level is absolutely identical with the amount taken up by the shareholder on his income tax return. This amount in the future probably will be referred to as the "gross dividend."

How the profit-distribution burden will be developed from the standard tax burden may be illustrated by the following simplified examples:

Calculation by the corporation:	
Profit before deduction of corporate income tax	100
Corporate income tax	(56)
Remaining profit	44
Reduction of corporate income tax because of distribution (standard tax burden of 56 less profit-distribution burden of 36)	20
Maximum distribution	64

As was mentioned, the second step that must be taken in order to eliminate the corporate tax burden completely is the crediting on the shareholder level of the 36-percent tax paid by the corporation, so that, as a consequence, ultimately the distributed profit is burdened only with the tax of the shareholder on the total of his taxable income.To word it differently, the income tax of the corporation is replaced by and in part substituted for the tax that the shareholder will have to pay on his share in the company's distributed profit. Consequently, the shareholder in his tax return must take up the profit that is established before deducting the 36-percent corporation tax. The dividend earned will consist of two elements in the future: the cash dividend received and the tax credit.

To continue the foregoing example:

Calculation for stockholder:		
Cash dividend		64
Capital withholding tax of 25%		(16)
Net cash to shareholder		48
Cash dividend		64
Tax credit: 9/16 of cash dividend received		36
Gross dividend		100
Assuming that the stockholder is in the 40% tax bracket, his personal income tax calculation would be as follows:		
Gross dividend		100
Tax payable		40
Available as credit:		
Capital withholding tax	16	
Corporation tax	36	52
Amount to be refunded		12

It has been assumed, and presumably very rightly so, that since the whole of the tax on the profit (in our case 52) is available as a credit against the personal income tax of the shareholder, there will be hardly any inducement for taxpayers not to declare their dividend income in the future, whereas this apparently has happened not infrequently under the old system. This is no doubt a welcome side effect for the government.

In practice, establishing the profit-distribution burden should not create great difficulty, because the reduction of the corporate income tax can be calculated as a fraction of the maximum distribution. In the above example, it is 20/64 or 5/16 of the cash dividend. In other words, in the future a corporation first will have to calculate the tax at 56 percent of taxable income. From this tax liability it will have to deduct the equivalent of 5/16 of the proposed cash dividend. The difference is the final tax liability of the corporation. It is composed of the 36-percent profit-distribution burden as to those profits to be distributed and the 56-percent standard tax burden on the balance of the income retained.

Along the same lines, namely by calculating the percentage by which the corporate income tax will change as a fraction of the cash dividend, one can also easily calculate how the standard tax burden will be changed to the profit-distribution burden if a profit is to be distributed. Normally a reduction, namely by twenty percentage points, will be the consequence. But as was mentioned above, a markup may also have to be made, as, for example, if tax-free income is distributed.

Stratification of the equity

It should be pointed out that the new law, as with the German income tax laws in general, does not speak of "profits" but of "equity," from which it proceeds to "distributable equity." For a particular year, this is actually the difference between the excess of the total equity over registered capital at the beginning and the end of a fiscal period. The general term *equity* had to be chosen for tax purposes because the law does not differentiate between the various periods in which the dividends distributed in a given year have originated. Therefore, to insure a complete elimination of the corporation income tax on amounts distributed, the tax burden on equity must be made uniform, regardless of the period of origin. To accomplish this, two conditions must be met:

1. The equity must be stratified into segments according to the different corporation tax rates that have been applied thereon.
2. Rules must be provided as to the sequence in which the various equity strata that have been burdened with income taxes at different rates are to be considered as distributed if and when such a distribution actually takes place.

The law stipulates that the stratification of the equity shall be made at the end of each fiscal year. In a normal situation, this stratification will result in three segments, and the segments will be deemed to have been distributed in the following order:

a) Equity burdened with 56-percent tax

b) Equity burdened with 36-percent tax

c) Equity not burdened with tax

"Equity not burdened with tax" specifically includes profits earned abroad that are exempt from German tax or where the particular tax, although perhaps lower, is available in Germany as a credit. The category also includes equity carried over from the previous system. Neither the foreign taxes paid currently nor the domestic taxes paid previously on profits realized under the old system count in determining whether equity has been subject to the standard tax burden.

Profits that have borne a rate of tax lower than the standard tax burden—for example, a net German tax after the allowance of a foreign tax credit—must be allocated to one of the three equity strata. This is done by dividing the profits into parts burdened with tax at 56 or 36 percent or unburdened, as appropriate. So, for example, if the rate of tax is 24 percent, two-thirds of the profits would be allocated to equity burdened with a 36-percent tax and one-third to equity not burdened with tax.

Special rules are also provided in connection with the stratification of equity for nondeductible expenses and operating losses. Nondeductible expenses are charged against equity burdened with 56-percent tax. By so reducing this equity, it is no longer available for distribution and, accordingly, not eligible for the 20-percent tax reduction or the 36-percent shareholder credit.

Operating losses are charged against profits of the year in which incurred, and the profits, as a result, are not burdened with tax to that extent. To the extent that losses exceed profits, they are initially charged against and reduce equity that has not been burdened with tax. In subsequent years, if profits are realized and the losses are carried forward and give rise to a deduction for corporation tax purposes (within the five-year carryforward period), the initial charge against equity not burdened with tax is restored by an addition thereto.

The fiscal authorities conducted an operations game in which a number of German companies of different sizes participated. Apparently it was proved that it is feasible for even the largest company, without incurring an undue amount of expense, to prepare this stratification of equity within a reasonable period of time.

Keeping a close watch on this calculation will be an important task of all who are responsible for the tax matters of a company. And, it may well be envisioned that, in future tax audits, realignments of these segments will present a major subject of contention. Effects of realignments would be felt not only when the realignment is made, but also if and when dividends are subsequently distributed. When equity is allocated to strata of higher tax burden, the tax liability of the corporation increases and its liquid funds are reduced. If later a dividend is distributed, the reduction to the lower profit-distribution burden works in the opposite direction.

Tax calculation in case of a dividend distribution

1. Out of equity fully burdened with tax:

Balance sheet, December 31, 1977

	DM		*DM*
Assets	350,000	Equity ("registered capital")	100,000
		Surplus	100,000
		Accrued income tax	50,400
		Undistributed profits from previous year	50,000
		Profit for year	49,600
	350,000		350,000

It is assumed that nondeductible items amount to DM20,000 and that furthermore the company has income of DM30,000 from foreign sources. This income has been included in the profit for that year, but has not yet been burdened with tax in Germany.

The accrual for income taxes is calculated as follows:

	DM
Profit for year	49,600
Add back: Corporation income tax	50,400
Other nondeductible items	20,000
	120,000
Deduct: Tax-free income (interest income earned abroad)	30,000
	90,000
Tax liability: 56% of DM90,000	50,400

In 1978, at the shareholders meeting that approves the 1977 financial statements and resolves the disposal of the profit, it is decided to distribute a dividend of DM10,000 out of the 1977 profit.

	DM
Calculation of tax credit:	
The stockholder is entitled to tax credit of 9/16 of DM10,000	5,625
to which the cash dividend of	10,000
must be added so that	15,625
would be the "gross profit" distributed.	
Originally, this gross profit was burdened with the standard tax of 56% or	8,750
This burden is now eliminated as follows:	
a) Tax credit to stockholder: 9/16 of DM10,000	5,625
b) Tax reduction at corporate level:	
5/16 of DM10,000, i.e., establishing the profit-distribution burden	3,125
Total as above	8,750

The reduction in the equity distributed of DM6,875 (i.e., DM15,625 less DM8,750) may be calculated in a more simplified way as follows:

	DM
Dividend	10,000
Less reduction of corporate income tax of 5/16 (i.e., from 56% to 36%)	3,125
Reduction in equity originally burdened by 56% tax	6,875

The remaining equity is DM42,725 and would be allocated to equity strata as follows:

	DM
Equity burdened with 56% tax (DM39,000 aftertax profits minus DM20,000 nondeductible items and DM6,875 distribution)	12,725
Equity burdened with no tax (interest income earned abroad)	30,000
	42,725

This remaining equity is available for distribution as a dividend in future years. Such a distribution may be made, for instance, if in the following year the company has zero income (i.e., no profit, no loss)—admittedly a rather hypothetical case, which is used here for illustrative purposes only.

The calculation then would be as follows if the same cash dividend of DM10,000 is paid:

	DM
Withdrawal of equity	6,875
Tax reduction at corporate level:	
5/16 of DM10,000 or	
5/11 of DM6,875	3,125
Cash dividend	10,000
Tax credit (if resident only):	
9/16 of DM10,000	5,625
Gross dividend	15,625

The remaining equity now will amount to DM35,850, DM5,850 burdened with 56-percent tax and DM30,000 burdened with no tax.

2. Out of equity that has been burdened with a reduced tax:

Assume that equity of DM14,400 has been burdened with a reduced corporation income tax at the rate of 28 percent and that the maximum distribution is to be made. In this case the profit-distribution burden would be calculated as follows:

Allocation of equity burdened with 28% tax to the 36%-burdened- and unburdened-equity strata:

Tax of DM5,600 × 16/9 = DM9,956 equity burdened with 36% tax

Equity of DM14,400 − DM9,956 = DM4,444 equity burdened with zero tax

Distribution

1. Out of 36% tax-burdened equity		DM 9,956
2. Out of unburdened equity	DM4,444	
less 36% tax	1,600	2,844
Maximum distribution		DM12,800

Hidden Profit Distributions

It is well known that the German tax auditors, who are organized as a well-staffed and quasi-autonomous branch of the tax administration, regularly audit every corporation in Germany over a three- to five-year interval. To do this, it sometimes takes them several months, or even more than a year. The tax auditors are known for their propensity to establish "hidden profit distributions." By this is meant any advantage in cash, in goods or in services that the corporation has granted its stockholder, which advantage, for the same price and under the same conditions, it would not have granted to a nonrelated person.

Under the old tax law, a hidden profit distribution actually draws a penalty, because as a profit it cannot be considered as "distributed pursuant to a stockholders' resolution." Consequently, it does not qualify for the reduced tax rate. In the future, under the new law, the reduction of the tax burden will be uniform and applicable to all profits regardless of how they are qualified by the tax authorities. This means that in the case of hidden profit distributions as well as actual distributions the effective tax rate will be only 36 percent. It has been suggested that because of this it will not be necessary in the future for the tax auditors to investigate whether a hidden profit distribution has taken place, and consequently a lot of time, worries and disputes would be saved. At least three arguments can be made in rebuttal of this suggestion:

1. Hidden profit distributions are burdened by municipal trade tax in addition to corporation tax. This is a separate tax under a separate tax system, and in no way applies for a tax credit.

2. In case of a hidden profit distribution, it is important to follow the "hidden dividends" through to the recipient shareholder and to assure that he takes them up on his tax return.

3. The credit of the 36-percent corporation income tax, as has been explained above, is not available to nonresident shareholders. Therefore, in the case of foreign subsidiaries in Germany, this problem of whether a hidden profit distribution took place retains its importance for all nonresident shareholders.

Inasmuch as the "penalty" for a hidden profit distribution will disappear in future, the tax authorities will realize that the preventive character that such a penalty doubtless constituted will also disappear. It might be expected that in the future, to make up for this elimination of a deterrent, they may develop a tendency to assert tax evasion more quickly in those cases where under the present system the taxpayer had the benefit of the doubt as to the treatment of a particular item.

Policy During Transition Period

The question of how the corporation should react to the new law during the period of changeover is a difficult one to respond to on a general basis. The profit-distribution policy of a company is influenced by many factors, taxation being only one. Some observations, however, can be made.

Within the framework of the valuation flexibility offered by the tax laws in Germany, the preparation of the last balance sheet, namely that of December 31, 1976, will decide whether the profits are taxed at the old or the new rate. For instance, German tax law grants a taxpayer the right to charge accelerated depreciation on certain assets within the first five years. The taxpayer at his discretion may shift the accelerated depreciation charge from one year to another, provided that the total in the first five years does not exceed certain percentages. Another example of flexibility in the timing of profits is in the inventory area. A reserve for higher replacement values for inventories may be set up in a given year to be restored to income over five consecutive years in amounts not in excess of 20 percent in each year.

The following general transitional rules might be applied: If equity is to be strengthened in that the distribution of earned surplus as a dividend is not planned for the foreseeable future, the old tax rate of 52.5 percent is 3.5 percent below the future standard tax burden. Thus, it would seem to be favorable to retain profits in 1976 or to accelerate profits to that year. However, the loss of interest on this difference which would be prepaid may more than eliminate the advantage, so that for most corporations the difference between the two burdens will be negligible.

If, on the other hand, profits are to be distributed, different rules must be applied depending upon whether the shareholder is domestic or foreign. It is more advantageous to "defer" profits to the new system where the shareholder is German, because, despite the higher tax rate, a German shareholder at least will earn a higher net dividend as a result of the tax credit. Inasmuch as the credit is not available, however, to nonresident shareholders, it seems to be more advantageous to make the highest distribution possible under the old system, because the split rate favors residents and nonresidents alike. It might even be advantageous to distribute profits retained in prior years, since the reduction of the split profit rate is available for the last time in 1976. Thus, the 1976 profit might be distributed at 100 percent and the 15-percent corporation tax paid out of earned surplus. In this way, the shadow effect can be eliminated. An example may further illustrate this point:

	Tax burden if tax is paid out of current profit
Taxable income	100.00
Corporation income tax if maximum distribution of 75.44 is made	24.56
Available as dividend	75.44

	Tax burden if tax is paid out of earned surplus after taxes
Taxable income	100.00
Corporation income tax on distribution	15.45
Available for distribution	84.55
Taken from earned surplus after taxes	15.45
Available as dividend	100.00

Position of Nonresident Shareholders

Because one of the principal effects of the new system is the increase in corporate tax rates, nonresident shareholders will be especially hard hit by the new system. Nonresident corporate shareholders may be able to offset this effect, at least in part, either by virtue of an "affiliation privilege" or by way of an indirect tax credit in their home country. Even if so, such nonresidents will suffer when compared with German residents, since the 36-percent tax credit is not available to them.

The effect of the new law on the German tax position of a distribution from a subsidiary of a U.S. company can be compared with that of the old system as follows:

	Old System	*New System*
Corporation tax	24.6%	36.0%
Capital withholding tax:		
(15% of 100 less 24.6)	11.3	
(15% of 100 less 36)		9.6
Total	35.9%	45.6%

The foreign-owned subsidiaries in Germany, through their representative bodies (such as the American Chamber of Commerce), have argued at the public hearings held by the Finance Committee of the German Bundestag that under the new system they would be suffering a distinct disadvantage as compared with domestic corporations. This disadvantage is, of course, especially significant in those cases where the double tax burden is not reduced or alleviated by a corresponding reduction in the capital withholding tax, as is provided for in a number of tax treaties.

Representatives of foreign industry in Germany further demonstrated to the German government, directly or indirectly, that the impact of the new law is unequal and unjust as far as their foreign parents are concerned. They suggested that the German Parliament when introducing the new law should instruct the German government to reduce the capital withholding tax rate to a uniform 15 percent. Parliament, however, has not gone that far. In the Preamble to the new law it has simply "recommended" to the government that it conduct such negotiations but without stipulating any time limit.

It must be reemphasized that the new credit system does not apply to nonresidents. Only when equity that originated in the pre-1977 period is distributed subsequently or when tax-free income that has been earned abroad is distributed will nonresidents be entitled to a refund of the tax burden of 36 percent of the amount distributed. And, of course, such refunds will simply compensate for the fact that the distributing German corporation was required to pay an equivalent amount.

Effect on U.S. Shareholders

The ultimate effect of the new system on U.S. shareholders, just as on other nonresidents of Germany, will not be known until such time as the U.S./Germany Income Tax Treaty is renegotiated. Such renegotiation could result in further reduction of the capital withholding tax rate (presently 15 percent) and/or in possible provision for refund to shareholders of all or part of the credit allowed to residents. In the meantime there will be uncertainty on the part of U.S. taxpayers as to how the new German system interrelates with that of the United States. The remainder of this discussion is directed toward the exploration of some of these uncertainties.

Before proceeding further, it should be pointed out that the actual German tax rates are substantially higher than the 36- and 56-percent rates previously discussed. The reason is that the municipal trade tax has been ignored in the preceding discussion. For German tax purposes there is logic to doing this because the trade tax is imposed at a constant rate without regard to whether profits are distributed, is not available as a credit to the German shareholder and is deductible in determining German taxable income. For U.S. tax-credit purposes, however, the trade tax cannot be ignored and cannot be deducted in determining German taxable profits because it is a creditable tax.

The effective German tax rates on distributed and undistributed profits more closely approximate 44 percent and 62 percent after giving effect to the trade tax. In the ensuing discussion we will use these effective rates rather than the 36- and 56-percent rates in determining foreign tax credits.

One question that will no doubt arise will be whether the 36-percent profit-distribution burden is tantamount to a withholding tax imposed on the shareholder and for which direct credit should be given to the shareholder in his U.S. return. This is a logical question in the light of the intent of the new German system to relieve fully the German corporate tax burden and in view of the fact that the German shareholder grosses up his dividend by the amount of the profit-distribution burden. The same question has arisen with varying degrees of intensity in the past, as France, Belgium, the United Kingdom and Canada have all adopted some form of an imputation system. To date, none of these systems has been held to give rise to withholding tax credits except where provision for such treatment has been made in a treaty. Ultimately, the question will have to be resolved in the context of the German corporate tax law itself, with reference to a determination of upon whom the 36-percent profit-distribution burden is imposed rather than who pays it or who ultimately bears its economic burden.

A more pertinent question than the status of the profit-distribution burden as a withholding tax may be how a U.S. parent corporation or other 10-percent or greater corporate shareholder will compute indirect credits or credits for taxes deemed paid by the German corporation on the earnings out of which a dividend is paid. Unlike the new German system, the U.S. tax law makes no provision for stratification of equity and ordering of distributions first out of the highest-taxed earnings, then out of lower-taxed and untaxed earnings. The U.S. rules simply provide that dividends are deemed to have come first from the earnings of the year in which the dividend is paid and, to the extent in excess, out of accumulated earnings in the reverse order of accumulation. Dividends paid in the first sixty days after the close of a year are deemed to have been paid in the preceding year for this purpose. A conflict of these rules with the German ordering rules can be foreseen and can be expected to create uncertainty if not confusion. Some examples may illustrate this point.

In the simplest example let us assume that all earnings for a particular year are distributed within sixty days of the close of that year, with the result that the earnings eligible for the reduced rate in Germany are also the earnings that are deemed to be distributed for U.S. purposes. Assume that the German corporation derived 100 of earnings on which it paid total German taxes of 44 and from which it distributed to a U.S. corporate shareholder a net dividend of 56. The U.S. tax and foreign tax credits would be determined as follows:

Cash dividend		56.0
Gross-up for taxes deemed paid		44.0
Taxable dividend		100.0
Gross U.S. tax		48.0
Foreign tax credit:		
Deemed paid	44.0	
Withholding tax (15% of 56)	8.4	52.4
Excess foreign tax credit		(4.4)

In a simple fact pattern such as this, the above calculation appears appropriate, whether the reduction in German tax rate from 62 to 44 as a result of the distribution is effected at the close of the year in which the earnings accrued or at a later date. This is because a refund would be received by the German corporation if the higher amount had been paid in the first instance, and it is well established for U.S. purposes that foreign tax refunds reduce foreign tax credits. Clearly the ultimate burden of German corporate tax in this example is 44, and that is the amount for which credit is obtained.

Let us assume differently, however, that only one-half of the earnings of a particular year are distributed. Assume that the German company had earnings of 200 and taxes paid of 106, consisting of 62 on the 100 of earnings that were not distributed and 44 on the distributed earnings. Assume that the U.S. corporate shareholder received the same cash dividend of 56. In this case the alternative results that might be calculated are as follows:

	Alternatives			
	1		*2*	
Cash dividend		56.0		56.0
Gross-up for taxes deemed paid:				
56/94 × 106		63.1		
56/112 × 88				44.0
Taxable dividend		119.1		100.0
Gross U.S. tax		57.2		48.0
Foreign tax credit:				
Deemed paid	63.1		44.0	
Withheld tax	8.4	71.5	8.4	52.4
Excess foreign tax credit		(14.3)		(4.4)

The result in alternative 1 would be the traditional result in the calculation of deemed-paid foreign tax credits in the United States. No attempt would be made to identify the specific earnings out of which the dividend was paid, and the dividend would be considered to have borne a proportionate share of the total taxes paid without regard to how those total taxes were determined under the foreign laws. The result in alternative 2 is predicated on a concept that would hold the difference between the tax on distributed earnings and the tax on undistributed earnings to be not creditable for U.S. purposes. This might be the case, for example, if it was considered in the nature of a prepayment, refundable if, as and when the earnings on which it was imposed are distributed as a dividend. This is not to suggest that this is the nature of that tax but rather simply to illustrate the differing results that can occur. It may also be of interest to note that the result in alternative 2 is identical with that in the first example, where it was assumed that all earnings would be distributed. This, of course, is what would happen in the case of a partial distribution if the profits were segregated into distributed and undistributed accounts for U.S. tax-credit calculation purposes.

Uncertainties similar to those just illustrated will arise in circumstances where a dividend is paid by the German subsidiary during the first sixty days following a taxable year, which for U.S. purposes will be deemed to have come from the preceding year but which for German purposes may be deemed to represent a distribution of current year's earnings. There will be a question of which rate is appropriate, for example, if in 1977 no distributions are made and German corporate taxes are, accordingly, accrued and paid at the 62-percent rate, but if in February 1978 a distribution is made that has the effect of reducing the rate on 1978 earnings to 44 percent.