What is going to change for Japanese companies and investors in Germany, when the new Double Tax Treaty comes into effect

Germany and Japan are connected by an historical trade partnership. A Japanese trading house was established in Düsseldorf as early as 1863. Today, more than 1,500 Japanese companies have established themselves throughout Germany. For these, and for future Japanese investors, the new Double Tax Treaty, which is expected to enter into force on 1 January 2017, will bring significant advantages. 50 years after the conclusion of the first such treaty, relationships are being brought to a whole new level.
The long-awaited renewal of the Double Tax Treaty

For Japanese companies, making investments in Germany will become more attractive

Germany is the gateway to Europe for Japanese companies

Germany is by far and away Japan’s most important European trading partner. As a single European country, the Federal Republic is among the 15 countries with the greatest volume of trade with Japan. In 2015, Germany imported goods to a value of more than 20 billion US dollars from Japan – more than Great Britain and France put together (UN Comtrade Database, 2016).

The most important export industries to Germany include mechanical engineering, as well as the electronics and automotive industries – traditionally strong domains of the Japanese economy. As a result of the volume and significance for the largest industrial sectors, the Federal Republic of Germany is the gateway to the European market for Japanese exporters.

Japan’s 15 most important trading partners in 2014 according to trading volumes (in bn. $)

<table>
<thead>
<tr>
<th>Country</th>
<th>Trading Volume (bn.$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>309.1</td>
</tr>
<tr>
<td>United States</td>
<td>201.2</td>
</tr>
<tr>
<td>South Korea</td>
<td>85.4</td>
</tr>
<tr>
<td>Taiwan</td>
<td>64.6</td>
</tr>
<tr>
<td>Australia</td>
<td>60.8</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>55.4</td>
</tr>
<tr>
<td>Thailand</td>
<td>53.5</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>51.6</td>
</tr>
<tr>
<td>Malaysia</td>
<td>43.6</td>
</tr>
<tr>
<td>Germany</td>
<td>43.4</td>
</tr>
<tr>
<td>Indonesia</td>
<td>40.7</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>40.0</td>
</tr>
<tr>
<td>Qatar</td>
<td>35.3</td>
</tr>
<tr>
<td>Russia</td>
<td>34.2</td>
</tr>
<tr>
<td>Singapore</td>
<td>29.0</td>
</tr>
</tbody>
</table>

Source: JETRO (Japanese External Trade Organization), 2016
At the same time, Germany is one of the most attractive locations for the direct foreign investment of Japanese companies. Since 2008, no other European country has recorded more Japanese greenfield investments than Germany. And the Federal Republic of Germany is also one of the most important destinations worldwide for M&As (Thomson One 2016).

Above all, Germany is of interest to Japanese companies as a result of it being the largest single market within the EU and because of its technological know-how. Outstanding infrastructure, an excellent technology cluster in the electronics, automotive and chemical industries, as well as well-trained skilled workers, engineers in particular, offer Japanese high-tech companies an excellent operating environment. The German software and IT industries relevant to Industry 4.0 and the market-dominating German technologies in the field of renewable energy increasingly encounter great interest from Japan.

Alongside this, however, Germany is also of great strategic importance. With its stable economic and political environment, the Federal Republic of Germany provides Japanese companies with a first-class commercial environment. From here on, the development of not only other EU countries, but also of the developing markets of eastern and southern Europe, culminating in Turkey, will also be driven forward.

Top 10 European target countries for Japanese greenfield investments since 2008 according to the number of projects

Source: fDi markets, 2016
Japanese companies invest in almost every sector

The distribution of Japanese investments in industrial sectors is similar to that for exports. 50 percent of all greenfield investments since 2008 were recorded in industrial manufacturing and in the automotive, software, IT services and electronics industries. Overall, however, Japanese investments are distributed across almost all sectors and portray thereby a very varied picture.

In contrast, Japanese investors have a geographical focus, primarily on North Rhine-Westphalia: A third of the greenfield investments since 2008 have been made there. Furthermore, the southern German states count for around 15 percent each of all greenfield projects. To a large extent, this concentration can be attributed to Düsseldorf, the capital of North Rhine-Westphalia, which traditionally plays host to by far the largest number of Japanese companies and residents. According to the Bank of Tokyo Mitsubishi, there were more Japanese employees working in Düsseldorf in 2014 than in Paris or London.

This is due to the excellent infrastructure for Japanese companies in the Düsseldorf area. It is not only the headquarters of the Japanese Chamber of Industry and Commerce that is located there. Japanese schools and nurseries, as well as Japanese speaking doctors are no rarity in Düsseldorf and increase the attractiveness of the location for Japanese employees.

On the other hand, however, this means that the potential of other German regions has largely still not been exhausted by Japanese investors. Over the last few years, the Rhein-Main region around Frankfurt and Hamburg have also established themselves as locations for Japanese companies in Germany, alongside those in the Düsseldorf/Rhein-Ruhr conurbation and the high-tech location of Munich. These locations also offer excellent structures for Japanese investors. Many of the regional chambers of industry and commerce, which orient themselves towards the success of pioneering Düsseldorf, now have Japan desks with Japanese speaking support services and good networking to the German Overseas Chamber of Commerce (AHK) in Tokyo.

Source: fDi markets, 2016
Due to tax benefits, the majority of large corporations opt for the United Kingdom as the home for their European headquarters. However, if one looks at the investment volume of all Japanese investment since 2008, more than three times as much capital flew into the United Kingdom as did into Germany, which finds itself in second place (fDi markets, 2016). This is due to the fact that Japanese corporations mainly opt to set up their central European offices in the form of a holding company in the United Kingdom, in order to be able to make use of tax benefits. At the same time, just looking at the volume of the direct investment fails to appreciate the increasing effects of globalisation. Productive subsidiaries of German and Japanese companies, for example, maintain significantly more extensive business connections by means of reciprocal value added contributions in Southeast Asia and Eastern Europe than direct or financial investment volumes would suggest.

On the other hand, the UK voted to leave the EU in June 2016. Therefore, it is doubtful that the capital flow into the United Kingdom continues at this level. Rather, it can already be recognized that investors put on hold their U.K. investment strategies due to the uncertain outcome of the negotiations between U.K. and the EU, which most likely will continue for years. In addition, the GBP exchange rate has already fallen dramatically.

The current Double Tax Treaty (DTT) between Japan and Germany goes back to 1967, and is therefore out of date. In comparison to European states, which have been preferred in recent times as the locations for the EU holdings of Japanese companies, the witholding taxes in Germany on dividends, interest and royalties are comparatively high. With the new edition of the Double Tax Treaty with Germany, these disadvantages are to be eliminated as of 2017.

The 10 most important European target countries for Japanese greenfield investments since 2008 according to investment volumes (bn. $)

<table>
<thead>
<tr>
<th>Country</th>
<th>Investment Volume (bn.$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>13.7</td>
</tr>
<tr>
<td>Germany</td>
<td>4.6</td>
</tr>
<tr>
<td>Turkey</td>
<td>4.34</td>
</tr>
<tr>
<td>Spain</td>
<td>4.25</td>
</tr>
<tr>
<td>Poland</td>
<td>2.99</td>
</tr>
<tr>
<td>France</td>
<td>2.75</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>2.07</td>
</tr>
<tr>
<td>Belgium</td>
<td>2.02</td>
</tr>
<tr>
<td>Romania</td>
<td>1.52</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>1.51</td>
</tr>
</tbody>
</table>

Source: fDi markets, 2016
The Federal Republic will thereby become more attractive to Japanese investors. Ultimately, the German domestic market is significantly larger than that of the British. Moreover, the most important clients for European business are based in Germany and the geographically central location offers itself as the perfect site for European headquarters.

**Changes in the Double Tax Treaty**
The most significant change for companies to the Double Tax Treaty between Germany and Japan concerns the withholding tax on dividends, interest and royalties.

In the past, a 15% withholding tax was charged on dividends, interest and royalty income. Furthermore, in the year 2009 the possibility of taking into account taxes paid abroad was excluded from Japanese law, whereby withholding tax became one of the major cost factors. This led to Japanese companies forming holding companies in countries with more favourable tax arrangements, such as Great Britain.

In this way, the dividends of the German company could initially be transferred tax-free to the holding company on the basis of the so-called mother-daughter EU directive (Directives 90/435/EEC, 2003/123/EC 2006/98/EC). By transferring the dividends from the holding to the Japanese parent company, the more favourable – often zero-percent – withholding tax rate of the relevant Double Tax Treaty between Japan and the country in which the holding company had its head offices, would be applied.

A holding in another EU country can be used to avoid withholding tax, insofar as the holding company is of sufficient economic substance. Pure “letter-box” companies do not have tax recognition. The European holdings are therefore enhanced with functions. German group subsidiary companies, despite being based in the most densely populated and economically most important EU member state, lose importance thereby.

**Situation before the change to the DTT**

- **Japanese Parent Company**
  - 0% WHT
  - DTT JP – UK

- **EU Holding Company in UK**
  - 0% WHT
  - Parent-Subsidiary Directive

- **German Subsidiary**

**Situation after the change to the DTT**

- **Japanese Parent Company**

- **German Subsidiary**

**Source:** KPMG, 2016
By eliminating withholding tax, Germany becomes more attractive as the location for European headquarters

As a result of the amendments to the Double Tax Treaty between Germany and Japan, withholding tax on dividends, interest and royalties is to be completely removed between the two countries, rendering it no longer necessary to process company profits via a holding in another EU country for tax reasons. Both the Federal Government of Germany and business representatives and associations expect this to result in an increase in Japanese direct investment.

The binding arbitration clause prevents double taxation in the future

A further important change to the Double Tax Treaty is the introduction of a binding arbitration clause. Until now, tax auditors have often found that the (internal) purchase prices for products from Japan to the German sales company were regarded as being too high and thus the profit of Japanese companies in Germany has been kept artificially low. The resulting profit reduction, which was unreasonable from the point of view of the tax auditors, was adjusted by means of a taxable profit increase in Germany. As this share of profits, which has only been raised for national tax purposes, has already been taxed in Japan, this leads to double taxation.

Through the introduction of a binding arbitration clause in the framework of the mutual agreement procedure, such double taxation will be avoided. In future, German and Japanese financial authorities must agree in advance on harmonised taxation during tax audits, for example, in relation to the intra-group transfer pricing, insofar as the mutual agreement procedure is initiated by the company.

What does this mean for Japanese companies?

Because of the abolition of withholding taxes and a current comparatively moderate average corporation taxation regime in Germany of under 30 percent, Japanese companies should put their European corporate structure to the test:

- Do the German subsidiaries adequately reflect the importance of the German market in comparison to other EU countries in terms of function, capital and personnel?

- Are business start-ups in Germany attractive, in a way that was previously not sensible for tax reasons?

- Against the background of the new Double Tax Treaty with Germany, can European company group structures in general be more effectively established and in a more streamlined fashion, possibly with the transfer of the holding location to Germany?

It is likely that the new DTT will increasingly lead to reorganisations at a European level. The relocation of functions, personnel and investments to Germany are to be expected. Some Japanese companies have already moved their European headquarters to Germany.

In addition, BREXIT might be another motivation for foreign investors to reconsider their business and value chain in Europe. It is to be expected that reorganizations are in particular considered in cases where non-European multinationals have either their European Holding in UK or a substantial part of their European value chain.
A free trade agreement could provide additional investment incentives in the future
Both sides hope that a free trade agreement between the EU and Japan, which is currently being negotiated, will serve as an additional impetus for more direct investment. In particular, this would be of benefit to companies from the Japanese automotive industry, which is already strongly represented in Germany.

Alongside this however, mechanical engineering and IT companies should also be focussed on in terms of new co-operations and investments, because the digital transformation under the heading “Industry 4.0” is largely being driven from Germany. In Japan, these developments currently enjoy a high reputation and lively interest, as the most recent focus events in both countries have shown.

German-Japanese economic relations continue to flourish
When the changes to the Double Tax Treaty between Japan and Germany enter into force, which is expected to take place on 1 January 2017, the fiscal framework conditions for both sides will improve. For Japanese companies, taxation aspects taken into account when choosing a location for a central European company headquarters will recede behind operational business-related decision criteria, such as proximity to customers, employee training levels and the size and availability of the market.

Direct investment between Japan and Germany will be mutually enhanced. Technological developments such as Industry 4.0 and the political will to approve a free trade agreement between the EU and Japan will also contribute to German-Japanese economic relations becoming even more dynamic in the future than was previously the case.

Finally, additional movement from indirect to more direct investment between Japan into Germany may come from the BREXIT decision of U.K. voters. In view of alternative locations in Europe, considering also strategic position in the EU, political stability, skilled workforce, productivity and domestic market size, Germany may have material advantages with other (continental) EU holding company locations (outside U.K.).
For your notes
Contact

KPMG AG
Wirtschaftsprüfungsgesellschaft
Tersteegenstraße 19–23
40474 Düsseldorf

Andreas Glunz
Managing Partner
International Business
T +49 211 475-7127
aglunz@kpmg.com

Country Practice Japan

Düsseldorf

Jörg Grünenberger
Partner, Tax
Head of Country Practice Japan
T +49 211 475-6404
jgruendenberger@kpmg.com

Yusuke Okamoto
Manager, Audit
T +49 211 475-6178
yokamoto1@kpmg.com

Frankfurt

Bernhard Schraut
Partner, Tax
T +49 69 9587-2022
bschraut@kpmg.com

Kenichi Koyama
Senior Manager, Tax
T +49 69 9587-1909
kkoyama@kpmg.com

Hamburg

Lars Behrendt
Partner, Tax
T +49 40 32015-5855
lbehrendt@kpmg.com

Yosuke Hisamatsu
Manager, Tax
T +49 40 32015-4022
yosukehisamatsu@kpmg.com

Munich

Ernst-August Baldamus
Partner, Tax
T +49 89 9282-1194
ebaldamus@kpmg.com

Daisuke Nakagawa
Senior Manager, Audit
T +49 89 9282-1517
dnakagawa1@kpmg.com

www.kpmg.de

www.kpmg.de/socialmedia

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2016 KPMG AG Wirtschaftsprüfungsgesellschaft, a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in Germany. The KPMG name and logo are registered trademarks of KPMG International.