

Tax and the Separation of Ownership and Control – Comment on the paper by Steven Bank and Brian R. Cheffins

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1. The Evolution of Ownership and Control in Germany

Commenting on the British and the American system of corporate governance is a challenging task from a German perspective. As Prof. Bank and Prof. Cheffins outlined, the United Kingdom's as well as the United States' economies are dominated by public companies with a broad shareholder structure. However, the patterns of ownership and control vary around the world. Germany, for instance, can be seen as one of the countries where a different system emerged; even though the starting positions had substantial similarities within the 19th century.

In my opinion, the main differences stem from the diverse basic models of organization of ownership and control underlying the two economies. Of course, there are also large companies in Germany with ownership dispersed among a large number of individuals and institutional investors. However, this is not the typical case like in the U.K.

According to current research¹ we primarily have to consider four basic aspects in order to describe the situation in Germany. First, there is still a high concentration of ownership and control. Although the structure of ownership differs in the course of time, block holdings are still common in Germany. Second, the importance of family-ownership slightly decreased in the course of time, but families are still a considerable force in building up large corporate dynasties or pyramids. Third, a pretty close network of cross ownerships among firms still exists. This network of crossholdings, which is often referred to as "Deutschland AG", shrunk over the last years but is still notable. Fourth, the capital market did not work efficiently in the past to build up a well functioning system of corporate control.

At the beginning of the industrialization in the 19th century, ownership and control used to be in the same hands in Germany; famous examples include Krupp, Thyssen, Stinnes, Wolff, Stumm, Klöckner, Siemens and Bosch. In this respect, starting points in the U.K. and Germany were similar to each other. However, from then on developments went separate ways. In Germany concentration of ownership stayed at a very high level concerning corporations, even after de-concentration was tried to be enforced after World War II. Furthermore, partnerships, with ownership and control being in one hand, retained their dominating position amongst legal forms for many reasons.

¹ See FOHLIN, *The History of Corporate Ownership and Control in Germany*, in: MORCK (ed.), *A History of Corporate Governance around the World*, 223-277 (2005) with further references.

The dominance of partnerships seems to be amazing at first glance, since entrepreneurial activity carried out by a publicly held corporation offers advantages like raising funds through the capital markets. However, raising funds through the capital markets, being a catalyst for the rise of corporations in the U.K., did not bear a meaning in Germany, since capital markets in Germany were not as developed as in Anglo-Saxon countries and debt-financing by banks was dominant. Instead, partnerships often offered more favorable conditions in many tax-related core issues.

- There was a tax bias against dividends and an advantage of partnerships until 1977 because of a classical corporate tax system. In this period of time distributed profits were taxed twice, first at corporate level and a second time at shareholder level.
- One of the main tax advantages that partnerships offer is the treatment of losses. This is because losses of a partnership are tax-relevant for the partners, whereas the losses of a corporation are not tax-relevant for the shareholders.
- Another advantage of partnerships is the favorable tax treatment of foreign investments. This aspect was of great importance in Germany.
- Furthermore, inheritance taxes are of big significance in Germany for the choice of the legal form. Once again partnerships offer substantial tax advantages.

The following comments are focusing on the question which impact tax had on the development of corporate ownership and control in legal forms apart from partnerships. In this context, it is important to bear in mind that tax is only one aspect alongside others. However, basic differences between the German and British fiscal system may have contributed to the diverse developments of corporate governance systems in the two countries.

Now I would like to touch upon the question whether tax was a catalyst for the exit of block holders. Since taxation of corporate profits was a key catalyst for the exit of block holders in the U.K., it is worthwhile to have a look at the German corporate income tax regulations. Prior to 1977 corporate taxation was based on a classical corporate income tax system which led to economic double taxation because the corporation's income was first taxed at corporate level and another time at shareholder level. In the case of a shareholder being an individual, dividends were taxed within the scope of personal income tax at pretty high tax rates. Also, the corporate income tax rates were relatively high with rates of 50% in 1948 and even 60% in 1951. From 1953 onwards, a split tax rate with a discount for distributed profits was in place. This was an unfavorable situation compared to the British imputation system, which did not trigger double taxation. This unfavorable situation could have incited block holders to sell their equity stakes or to foster the building of corporate pyramids. Subsequent corporate income tax systems, namely the imputation system implemented in 1977 and the shareholder relief model implemented in 2001 also did not trigger the intention for individuals to exit. This was because compared to other countries tax rates were high, but finally did not have a throttling effect. Hence, similar to the British situation corporate income tax burdens did not have the power to force block holders to exit. It also has to be mentioned that there were not similarly grave additional tax burdens to finance World War II in Germany.

Beside bearable charges at corporate level, subsequent taxation of dividends at shareholder level might cause a potential impulse for block holders to exit. This applies especially to the situation until 1977, because full personal income tax was levied on dividends. The situation improved after 1977 due to the implementation of the imputation system and the succeeding shareholder relief model. Therefore there was no economic obligation for shareholders to exit. However, traditionally it was standard practice in Germany to retain most of the profits at the corporate level and to distribute only a smaller part.

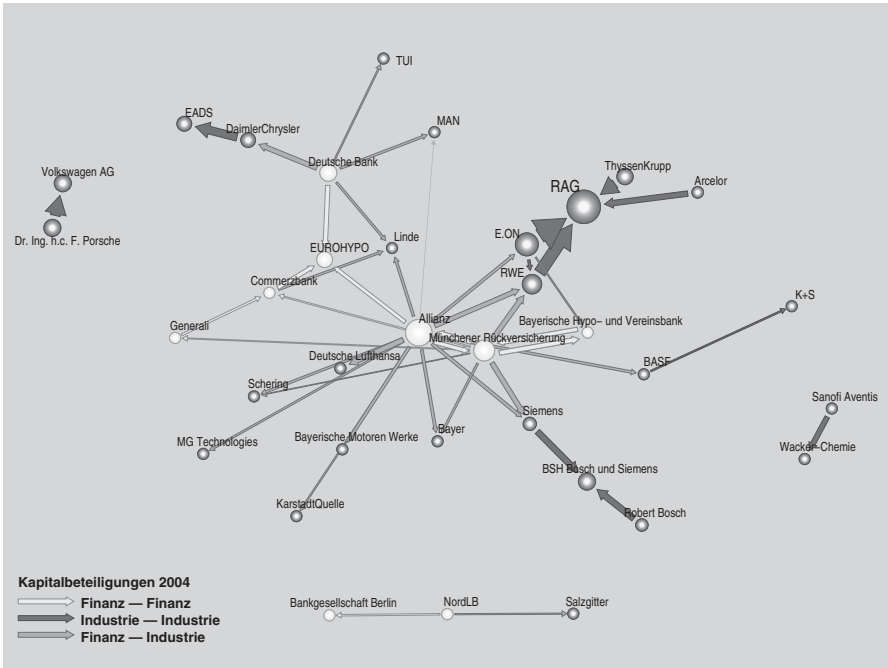
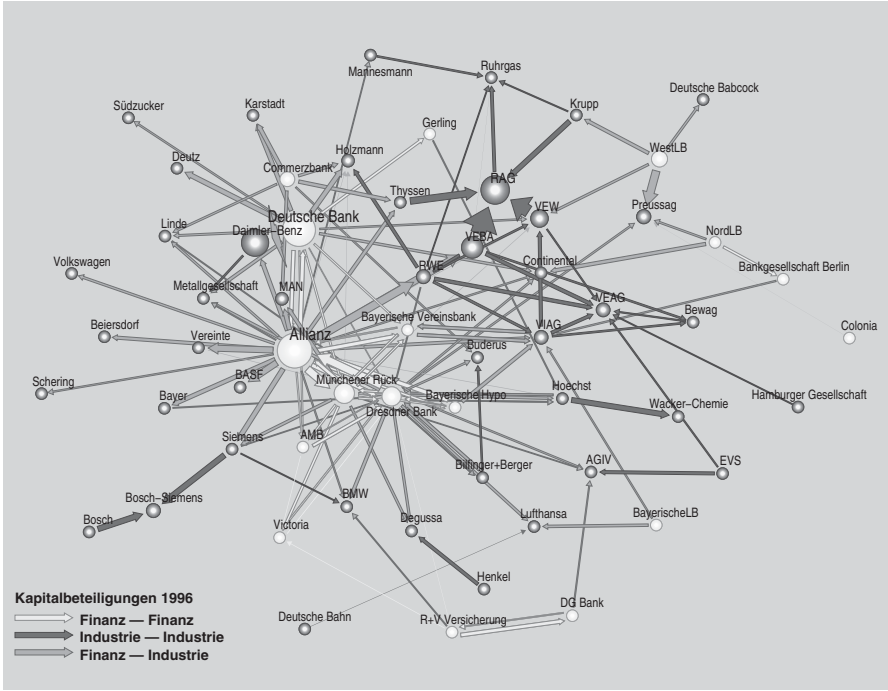
If we look into exit-taxation, tax legislation did not prevent disposals of share-blocks but even promoted them. Until the end of 1998 disposals of share-blocks comprising less than 25% of the shares were absolutely free of tax, as long as the disposal was not a matter of speculative gain. In the case of equity stakes bigger than 25% a yearly disposal of 1% of total nominal equity was tax-exempt. If a block holder owning a stake of more than 25% of total equity sold his stake or more than 1% of it, the transaction was taxed at half of the average income tax rate, always less than 30%. In my opinion this is a very favorable exit-taxation.

In case of a corporation being the shareholder, until 1977 treatment of dividends depended on which kind of equity holding the corporation owned. In case of a holding of less than 25%, dividends were fully taxed. However, in case of a material holding of at least 25% dividends were tax-exempt due to an affiliation privilege. Under the regime of the imputation system, distributed dividends did not cause any multiple-taxation at all. Since 2001, inter-corporate dividends are tax-exempt by Art. 8b Para. 1 ITA as well as disposals of equity-stakes are tax-exempt by Art. 8b Para. 2 ITA within the scope of the shareholder relief model. The general tax-exemption of share disposals can be considered a substantial tax incentive for block holders to sell their stakes. Latest research suggests that there has not been an equivalent shift in the structure of German share ownership for decades as compared to the break up of crossholdings in the period starting 1997 until today.²

However, disposals of block holdings already began around 1997 when a general tax-exemption for share disposals had not yet been implemented. Therefore, tax certainly contributed to the reduction of crossholdings, but apparently was not the sole motivation for the selling activities of block holders.

To summarize, tax could have been a motive for block holders to exit and furthermore provided them with attractive incentives for disposals.

² See also the charts on the following page, taken from HÖPNER/KREMPEL, *The Politics of the German Company Network*, 8 Competition and Change 229 (2004); KREMPEL, *Die Deutschland AG 1996-2004 und die Entflechtung der Kapitalbeziehungen der 100 größten deutschen Unternehmen*, in: REHBERG (ed.), *Die Natur der Gesellschaft* (2008).



Crossholdings in Germany 1996 and 2004.

2. Taxation and Demand for Shares

Given the previous findings, we have to evaluate the impact tax had on the demand for shares. In doing so, a distinction between demand of individuals and of corporations has to be made, since results clearly differ.

2.1 Demand of Individuals

As already presented, due to the double taxation and high income tax rates investments in shares were not tax-attractive for individuals within the scope of the classical corporate income tax system. Demand for shares therefore was restricted instead of fostered. In 1977, the imputation system was implemented in order to foster individual share ownership and thereby let the population participate in the productive property of the economy. Looking back in history this target was missed, since share ownership of individuals further shrunk until the emergence of the new economy bubble. Reasons for this development are not completely obvious, but different other tax-aspects might have mattered to some extent. First, alternatives existed that were more attractive for individuals, like buying tax-exempt life insurances. Also, investments in partnerships in general and tax shelter companies (loss allocating companies) in particular were more attractive.

2.2 Demand of Non-Financial Corporations and Financial Institutions

In contrast to individuals, non-financial corporations as well as financial institutions increased their share property significantly. After World War II, non-financial companies became Germany's dominant shareholders by boosting their equity participation in German corporate economy from 18% in 1950 to 41% in 1996. Banks and insurers increased their equity participation from around 11% in 1960 to 23% in 1998 whereas private households halved their equity participation to 15% until 1998. Considering the significant demand for shares of corporations and financial institutions the role tax played is not absolutely clear. Until 1977, acquisition of shares was not sponsored by tax-incentives. On the contrary, the classical corporate income tax system punished inter-corporate dividends by multiple taxation as long as the stake owned in a different company did not reach 25%, the threshold for the affiliation privilege. Therefore, tax might have contributed to the emergence of major crossholdings among companies, since dividends between affiliated companies were tax-exempt in the case of stakes bigger than 25%. In the period after 1977, also acquisitions of smaller stakes were favorable regarding tax-considerations. The same situation was given for insurance companies because of special tax rules for these corporations.

3. Conclusion

To summarize, tax might have played a role for the development of the German system of corporate governance. However, contrary to the British situation, tax does not seem to be a dominant force for the German pattern of ownership and control.

Especially the persisting concentration of ownership and the densely networked cross-ownership among companies cannot be explained in isolation by tax-matters.

The most obvious influence tax might have had on ownership and control presumably has to be seen in the tax-exemption of share disposals in 2001, which fostered de-concentration among German companies. However, developments caused by this regulation might be too young to be entirely explainable today.