12. Taxation of companies' foreign profits

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Summary

- In June 2007, the Treasury and HM Revenue & Customs proposed moving away from taxing the dividends that UK companies receive from their foreign subsidiaries (having given a credit for any foreign taxes paid on those dividends) to a system in which foreign dividends are exempt from UK taxation altogether.
- Moving to an exemption system should increase the after-tax profitability of UK multinationals by allowing them to compete for control of firms in low-tax countries on a level playing field with multinationals in other exemption countries. The tax system would be less likely to distort investment decisions unhelpfully.
- An exemption system is more likely to be compatible with EU law than the current 'credit' system. In principle, an exemption system should also be simpler and cheaper for companies to comply with, but the government's reforms involve unnecessary complexity that would probably squander these potential gains. The proposed exemption system could be simpler if: exemption for foreign dividends included as few exceptions as possible; dividends arising from small and large shareholdings were dealt with on the same basis; and if no distinction were drawn between small, medium and large company recipients.
- The document also proposes changes to the definition of controlled foreign company income, which potentially have wide-ranging impact. The current *entity*-based regime would be replaced by an *income*-based regime. This would broaden the category of foreign income that the UK government attempts to tax (largely passive income) and increase the scope for capturing such income.

12.1 Introduction

In June 2007, the Treasury and HM Revenue & Customs (HMRC) issued a discussion document setting out proposals aimed at creating a more straightforward regime for taxing the foreign profits of UK companies.[1] The main proposal was for the UK to move from its current system of taxing foreign dividends after giving a credit for taxes paid to foreign governments to a system in which foreign dividends are exempt from UK taxation. This would bring the UK in line with most other European countries. In addition, the document proposed overhauling the way in which the government tries to discourage companies from shifting profits to subsidiaries in countries with lower corporate tax rates.

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[1] HM Treasury and HM Revenue & Customs, *Taxation of the Foreign Profits of Companies: A Discussion Document*, June 2007 (http://www.hm-treasury.gov.uk/media/E/B/consult_foreign_profits210607.pdf).

Section 12.2 highlights how the current system operates, while Section 12.3 sets out the main economic principles that guide how we think about the taxation of foreign income. Section 12.4 outlines the specific proposals made in the discussion document and Section 12.5 comments on the implications of the proposed changes, including the likely revenue impact. Section 12.6 concludes.

12.2 The current UK system

The credit system

UK-resident companies are taxed on profits that are earned overseas. In order to avoid double taxation, HMRC generally gives UK companies credit against their UK corporation tax bill for taxes that have been paid on the income earned overseas. Any credit is limited to the amount of corporation tax due in the UK.

To illustrate how the UK credit system operates, consider a UK-resident company that has a subsidiary based in Ireland (where the corporation tax rate for traded income is 12.5%). The subsidiary earns profits of £100 of which £12.50 is paid to the Irish government in corporation tax and the remaining £87.50 is paid as a dividend to the UK parent company. The UK parent then faces corporation tax of 30% on the pre-tax value of the dividend (i.e. £100) while receiving a credit of £12.50 for the tax that has already been paid. The tax liability, £30, net of the tax credit, £12.50, leaves the firm with a UK tax bill of £17.50 and a net dividend income of £70. This is equivalent to the net dividend income that would have resulted from earning the £100 profits in the UK and paying 30% corporation tax. Since the tax credit is limited to the UK corporation tax rate, dividends remitted from countries with a higher tax rate face the tax burden of that country with no additional tax paid in the UK.

The European Court of Justice

The current system means that dividends paid out of foreign profits are treated differently from dividends paid out of domestic profits. Dividends received from an overseas subsidiary are treated as taxable income with a credit issued for corporation tax paid to the foreign government. Dividends/profits received from a domestic subsidiary are exempt income of the UK parent and therefore require no credit. In most cases, it would make no difference to the final tax liability were profits from domestic subsidiaries taxed under a credit system. However, there are circumstances under which it will make a difference (for example, if the subsidiary is subject to tax losses or faces corporation tax at the lower small companies' rate). This disparity led a number of companies with overseas subsidiaries to challenge the UK regime for taxing foreign dividends as fundamentally incompatible with Community Law in the European Court of Justice (ECJ).

The ECJ decided that taxing foreign dividends with credit while exempting domestic dividends was not necessarily incompatible with the requirements of Community Law, provided the UK was not effectively imposing a higher burden of taxation on investment overseas than it does on investment domestically. The ECJ concluded that the treatment of foreign direct investment was consistent with Community Law but that the treatment of portfolio investment was not (because in the latter case there is no credit for any underlying tax paid).[2] The proposals set out in the discussion paper are in part designed to make the whole UK regime for the taxation of foreign profits consistent with Community Law.

The 'controlled foreign company' (CFC) regime

The UK normally taxes the profits of foreign subsidiaries only when they are remitted to the UK in the form of dividends. This means that UK multinational companies have the scope to defer UK taxation indefinitely by keeping the profits of their foreign subsidiaries offshore. To counter this, the UK operates a controlled foreign company (CFC) regime that limits the extent to which companies can defer UK tax by retaining profits offshore in a jurisdiction with a lower corporation tax rate.

Broadly speaking, a company is treated as a CFC if it is resident outside the UK, is subject to a tax regime with a significantly lower level of tax than the UK (less than 75% of the tax rate applied in the UK) and is controlled by UK residents. In such cases, the UK-resident company is taxed on the proportion of the profits of the CFC that can be attributed to the UK by virtue of the size of its shareholding (provided that such profits account for at least 25% of the total profits of the CFC).

The UK CFC regime has also been subject to challenge before the ECJ. In the *Cadbury Schweppes* case, it was argued that the UK's CFC regime treated investments in subsidiaries in other EU countries less favourably than investments in domestic subsidiaries (because foreign profits were subject to immediate taxation in the hand of the parent but domestic profits were not). The ECJ decided that the CFC regime did infringe Community Law in this respect, as it impeded foreign investment. But the ECJ recognised that the UK might be able to justify its measures provided they were shown to be adequately targeted against attempts to avoid tax.[3]

12.3 Principles guiding the taxation of foreign profits

Before discussing the Treasury's specific proposals for an exemption system, we highlight three principles that should help guide us in deciding how foreign profits should be taxed.[4]

The first principle is **neutrality**: a well-designed tax system should not distort decisions over how much investment occurs, where investments are made and who undertakes the investment (unless there is a specific intention to influence those decisions).

Three important types of neutrality are emphasised by economists:

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[2] Case C-446/04 *Test Claimants in the FII Group Litigation*. Foreign direct investment is investment where shareholding amounts to at least 10%. Portfolio investment is where it is less than 10%.

[3] Case C-196/04 *Cadbury Schweppes*.

[4] For further details and discussion, see R. Griffith, J. Hines and P. B. Sørensen, 'International capital taxation', paper presented at IFS conference 'Reforming the Tax System for the 21st Century: The Mirrlees Review', New Hall, Cambridge, April 2007 (http://www.ifs.org.uk/publications.php?publication_id=3942). Also see M. Gammie, 'Taxation of foreign profits: response to HMT/HMRC's June 2007 Discussion Paper', mimeo, forthcoming.

- *capital import neutrality* (CIN) – this is achieved when investments into the domestic jurisdiction from abroad are treated the same for tax purposes regardless of the country of origin;
- *capital export neutrality* (CEN) – this is achieved when investments outside the domestic jurisdiction are treated the same for tax purposes regardless of the destination;
- *capital ownership neutrality* (CON) – this is achieved when inward or outward investments are treated the same for tax purposes regardless of who owns them.

It can be difficult for a single country to achieve neutrality across all these dimensions since the extent to which they are realised is in part dependent on the systems operated by other jurisdictions.

Alongside neutrality, simplicity and stability are also guiding principles of a good tax system. **Simplicity** helps ensure that compliance with the rules of the tax system does not impose unnecessary costs. **Stability** reduces uncertainty about future tax regimes, which can make it difficult for firms to plan and provides a disincentive for investment.

12.4 The June 2007 proposals

Foreign dividend exemption

The Treasury and HMRC propose a dividend exemption system, whereby profits repatriated to a UK-resident company from abroad are not liable for UK corporation tax and therefore require no credit for tax paid overseas. The tax burden on foreign income would be determined by the corporate tax rate in the foreign jurisdiction where the overseas investment took place. The stated aims are to simplify the tax treatment of foreign profits, make the rules more certain and straightforward, and increase the competitiveness of the UK's tax system.

Following from the above example, the dividend of £87.50 remitted from the Irish subsidiary to the UK-based parent company would not be liable to UK corporation tax under an exemption system (unless the income were classified as 'passive' or 'mobile' under the new 'controlled company' (CC) regime, see below). The burden would remain that imposed by the Irish government, namely 12.5%.

Currently, profits earned in foreign branches are treated differently from profits earned in foreign subsidiaries. The Treasury and HMRC do not make any proposals for changing the taxation of profits from foreign branch operations; these would continue to be taxed in the UK with credit given for foreign taxes already paid.

The 'controlled company' (CC) regime

The dividend exemption system introduces an incentive for investors to move financial assets abroad to countries with a lower corporation tax rate, then to repatriate the returns as tax-free dividends and so benefit from the lower foreign tax rate. To protect the domestic tax base, the Treasury and HMRC propose replacing the existing CFC regime with a new 'controlled company' (CC) regime.

One of the big changes is that the current CFC regime applies to *entities* whereas the new CC regime applies to *income*. In order to understand the implications of this change, it is first useful to define passive and active income. 'Active' income is income from commercial activities, while 'passive' income is mainly investment income such as interest, dividends (other than dividends flowing within the controlled group), royalties and rents.

Under the CFC regime, both active and passive income are liable to UK taxation if a subsidiary is defined as a CFC. There are a series of exemptions from being defined as a CFC, including an exemption for active trading subsidiaries. Provided it does not compromise its exempt status, a company is able to mix passive with active income in a trading subsidiary (or trading subgroup) in order that the former goes untaxed in the UK.

In contrast, under the proposed CC regime, all passive income would be liable to UK corporation tax. Most importantly, all of the passive income in 'active' subsidiaries would fall under the CC regime whereas this income is mostly not captured under the current CFC regime.

Alongside this, there is a change to what is considered as passive and active income (although the terms active and passive income are not used in the existing system, the concepts are there). The biggest change is to treat mobile active income as passive income. 'Mobile' income is income that can be easily transferred to different parts of the company and can therefore be located outside the UK to reduce tax liability.

The controversial element of this proposal is the intention to tax 'active income to the extent that it is, in substance, passive income'. In particular, in the discussions that followed the publication of the proposals, it has become apparent that the Treasury and HMRC envisage this including income that is attributable to intangible assets (such as brands), even when they are employed in an active business. Under the new CC system, the passive income and mobile active income of a controlled subsidiary of a UK parent company would be apportioned to the UK parent and subject to UK tax on a current basis, with a credit for any foreign (and, presumably, UK) taxes paid.[5]

Another big difference between the regimes is that the CFC rules apply to subsidiaries located in countries that have a tax rate that is less than 75% of the existing UK tax rate (so for the current UK rate of 30%, this is less than 22.5%), while the new CC rules will apply to subsidiaries located in any jurisdiction.

An important feature of the proposed CC regime is that it applies to domestic as well as foreign subsidiaries of the UK parent, such that the passive income from UK subsidiaries would be treated the same as that from foreign subsidiaries. The implications for current UK corporation tax rules (e.g. for losses) of having the CC regime apply to domestic subsidiaries, the aim of which presumably resulted from concerns that the proposed CC regime would be incompatible with EU law unless it were extended to UK subsidiaries, were not explored in the discussion document.

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[5] The apportioned income must represent at least 10% of the profits of the CC (a reduction from the 25% required under the CFC regime) before tax liability is triggered. Alongside this, there are a series of exemptions for passive income that is the result of genuine active finance, banking and insurance business.

Treatment of small businesses

Small businesses – those with fewer than 50 employees and a turnover not exceeding €10 million – would not be eligible for the new exemption system and would instead continue to be subject to a simplified version of the current credit system. Only the passive income part of the CC regime would apply to small companies, with the possibility of complete exemption from the CC regime if consolidated profits fall below a certain limit. As under the current CFC regime, a gateway test would determine which small businesses attract tax.

Interest relief allowance

Having volunteered to give up taxing most foreign dividends, the government has proposed recouping some revenue by tightening the rules that allow companies to deduct from taxable profits interest payments on borrowing. The total interest deduction claimed by the UK members of a multinational group would be restricted by reference to the group's total consolidated external finance costs. If the UK members of the multinational have higher finance costs than the overall external finance costs of the entire group, HMRC would see this as an indication that interest expenses have been allocated to the UK subgroup artificially with the purpose of reducing the entire group's worldwide tax bill.

Summary of proposals

In summary, the main features of the discussion document proposals are as follows:

- The foreign dividends received by companies resident in the UK from overseas subsidiaries would be exempt from UK corporation tax if the UK firm had a 'participation' holding (a shareholding of at least 10% in the company issuing the dividends) and was not small (defined as companies with fewer than 50 employees and a turnover not exceeding €10 million).
- The current entity-based controlled foreign company (CFC) regime would be replaced with an income-based controlled company (CC) regime, where the latter includes UK as well as foreign subsidiaries.
- Under the CC regime, the passive income of a controlled subsidiary would be apportioned to the UK parent company and taxed on a current basis with credit given for any foreign taxes paid. This applies to both UK and foreign subsidiaries and includes interest (other than certain intra-group interest), dividends (other than those flowing within the controlled group), royalties, rents and some realised capital gains.
- Certain mobile active income of a controlled subsidiary (both UK and foreign) of a UK parent company would be subject to the same tax regime as passive income.
- UK and foreign portfolio dividends (where the UK firm has less than 10% shareholdings) would be taxed or exempted from tax on the same basis.
- Small businesses would be subject to a simplified version of the current credit system.

- There would be some changes to the interest relief rules, restricting the amount of interest UK members of a multinational group are able to claim with reference to the group's total consolidated external finance costs.

12.5 Implications of the proposed exemption system

Would the proposed system move us closer to neutrality?

The extent to which the different types of neutrality (CIN, CEN and CON) are realised depends not only on the UK tax system but also on the systems operated by other jurisdictions. A single country cannot achieve all of these types of neutrality unilaterally.

Faced with a choice between CIN and CEN, it has usually been argued that, from a global perspective, CEN should take precedence over CIN. The reasoning is that when investors face the same effective tax rate on foreign and domestic investment, the cross-country equalisation of after-tax rates of return enforced by capital mobility ensures that pre-tax rates of return are also brought into line. In this way, a regime of CEN would tend to equalise the marginal productivities of capital across countries, as required for maximisation of world income.[6]

Box 12.1. Does a credit system achieve CEN?

As a credit system, the current UK regime is based on the principle of capital export neutrality. CEN is designed to ensure, from the residence state's perspective, that its tax system does not distort the decision of where to invest, by ensuring that investment faces the same tax rate wherever it is made. However, in practice, there are two important reasons why a credit system fails to achieve CEN, reflecting the practical difficulty of taxing foreign profits other than when they are remitted to the residence state in the form of dividends paid by foreign subsidiaries.

First, the UK limits the foreign tax credit to the amount of domestic tax payable on the foreign-source income in order to prevent taxes levied abroad from eroding the revenue from tax on domestic-source income. In the absence of limits on foreign tax credits, the governments of source countries could appropriate the revenues of residence countries through high source-country tax rates without deterring inbound investment. Because of the limitation on credits, investors are subject to the higher of the foreign and the domestic tax rate, whereas CEN requires that they should always face the same tax rate whether they invest at home or abroad.

Second, domestic taxes are deferred on the active business income of foreign subsidiaries until this income is repatriated in the form of a dividend to the domestic parent company. Profits retained abroad are thus only subject to the foreign corporation tax, so for retained earnings existing credit systems tend to work like an exemption system.

[6] The 1999 Inland Revenue discussion document, *Double Taxation Relief for Companies* (http://www.hmrc.gov.uk/consult/dtrc.pdf), stated that, historically, the UK has aimed at achieving CEN although the practical outcome does not conform to the principle.

A credit system of international double tax relief brings us closer to CEN than an exemption system: an investor resident in a single country faces more similar tax rates on their investments in different countries under a credit system than under an exemption system. However, in practice, and under the current UK credit system, CEN does not prevail, for a number of reasons, as described in Box 12.1.

A particular asset or investment may be much more productive in the hands of one multinational than it would be in the hands of another, so it is important that the tax system does not distort the pattern of ownership. CON is achieved if all countries practise worldwide income tax using the same tax base and unlimited tax credits or, alternatively, if all residence countries exempt foreign income from domestic tax and apply the same rules for deducting financing costs. While neither of these options is close to being complete, moving to an exemption system would move the UK closer to CON, especially since many other countries also operate exemption systems. Under a pure exemption system, investments in any single location would be liable for the same tax regardless of their country of origin. As a result, the

Box 12.2. Taxation of foreign-source income and productivity

If global ownership neutrality is the policy goal, the exemption system is just as attractive as a system of worldwide taxation with foreign tax credits. Moreover, if optimisation of the ownership pattern is the overriding goal, the exemption system is actually the preferred policy from the national viewpoint of an individual country, as argued by Desai and Hines (2003).[a]

If a country has a credit system like that which operates in the UK, its multinationals will tend to earn a lower after-tax return on operations in a foreign low-tax country than will multinationals headquartered in countries that exempt foreign income. Assets invested in low-tax countries will therefore tend to be taken over by companies based in exemption countries, even if those assets could be used more productively by companies based in countries with a worldwide system.

By giving up the current credit system and switching to exemption, the UK could increase the prices that its multinationals are willing to pay for assets located in foreign low-tax countries, enabling domestic companies to take over assets that they can use more efficiently than companies based in other countries. (This assumes that the home countries of foreign multinationals do not offer special tax advantages that reduce the costs of acquisitions. In practice, this assumption may not always hold. For example, it seems that one of the reasons why Spanish firms have outbid other companies in recent years is their ability to write off goodwill for tax purposes.)

Thus a policy of exemption would maximise the after-tax profitability of domestic multinationals. A country seeking to maximise the sum of its tax revenue and the after-tax profits of its companies would therefore opt for the exemption system if such a system does not reduce domestic tax revenue raised from domestic economic activity. This condition would be met if any increase in outbound investment triggered by a switch to exemption were offset by an equally productive amount of new inbound investment from foreign firms.

[a] M. Desai and J. Hines, 'Evaluating international tax reform', *National Tax Journal*, 2003, 56: 487–502.

assets invested in each country would be held by those companies that could earn the highest pre-tax (and hence highest after-tax) return on them. More details are contained in Box 12.2.

What impact might the reform have on investment?

The impact of the proposed reform would depend in part on how investors respond and how other countries tax foreign earnings (and whether they change the way they do so in response to the UK reforms). The former would be affected by the change in investors' incentives, how these incentives can be manipulated by investors (or tax lawyers and accountants) and how responsive investors are to changes in the after-tax returns from different investments.

How big an impact would the proposed exemption of foreign dividends have on after-tax returns to investment? One reason why the exemption of foreign dividends might not have a very big impact is that a credit system where the tax liability is deferred until profits are repatriated (as we currently have in the UK) is roughly equivalent to an exemption system. This is the case since the payment of UK corporation tax can be deferred indefinitely by maintaining the dividends offshore. To the extent that such dividends are not apportioned to the UK parent firm under the CFC regime, they remain tax-exempt. Research using data for US multinationals suggests that for this reason the behavioural effects of a switch to exemption may be very limited.[7]

In as much as the current system is effective as a credit system, UK-based parent companies are at a disadvantage compared with firms located in countries that exempt foreign-source income (most European countries). This disadvantage would be removed under the new system, increasing the after-tax return to some investments. However, the disadvantage is only relevant for investments into countries with lower tax rates than the UK, since (even with deferral) the net dividend income is the same in both the credit and exemption systems when the subsidiary is based in a jurisdiction with the same or a higher tax rate.

The ownership neutrality implied by an exemption system could help UK multinationals make more productive use of their assets. The current UK taxation of foreign dividends discourages UK firms from investing in low-tax countries more than do the tax systems that apply to companies in exemption countries with which they compete. With a switch to exemption, UK multinationals may relocate some of their overseas activities from foreign high-tax to foreign low-tax countries to take advantage of increased after-tax profitability.

A move by UK firms to relocate some of their domestic activities to foreign low-tax countries could also result in reduced rewards from UK fixed factors of production (e.g. lower wages for workers) and reduced UK tax revenues (if firms from other countries do not sufficiently increase their investment in the UK).

Would the reforms simplify the system and cut compliance costs?

While in principle the exemption system is simpler, it is not clear that simplicity is borne out in these particular proposals. In particular, exemption has been qualified in a number of ways,

[7] H. Grubert and J. Mutti, *Taxing International Business Income: Dividend Exemption versus the Current System*, AEI Studies on Tax Reform, American Enterprise Institute, Washington, DC, 2001.

with different treatment for different forms of dividends, different types of investment and different-sized companies. Complexity is also increased by the number of exemptions employed in the CC regime to define passive and mobile income. It would be surprising if a system that encompassed such variety proved to be significantly simpler than the current credit system.

A simpler system would be one where:

- corporate exemption for foreign dividends included as few exceptions as possible;
- portfolio (shareholding of less than 10%) and participation (at least 10%) dividends were dealt with on the same basis; and
- no distinction were drawn between small, medium and large company recipients.

To the extent that such a system would give rise to a potential increase in avoidance, this could be tackled in other ways – for example, through the CC regime and transfer pricing rules.

Even if the new system were simpler, there is a concern that the new CC regime could introduce significant administrative costs. The Treasury notes in the discussion document that many companies already have an appropriate reporting process in place to provide the necessary information to comply with the CC requirements. Furthermore, any additional costs that would arise should be set against a reduction in overall costs resulting from introducing exemption and removing the Treasury consent rules for certain overseas transactions. Much will depend on the final form and scope of the CC regime.

Would the new system make it easier to comply with EU law?

The new system may have the benefit of aiding compliance with EU law. Although the European Court has decided that both credit and exemption systems are capable of being compatible with EU law, we believe that it is easier to achieve compatibility with an exemption system than it is with a credit system. In principle, an exemption system ensures that the return to investment is taxed in the source state only and it therefore respects the choices that the source state has made for the taxation of investments within its market without interference (and double taxation) by investors' residence states.

Why treat small businesses differently?

The discussion document says that 'the Government does not consider it appropriate to take a uniform approach to foreign profits across all businesses'. As outlined above, small businesses would continue to be subject to a simplified version of the current credit system. Inevitably, this would complicate the system, and it is not apparent why the same profits in different hands should be taxed differently. If there is a case for producing a more straightforward and modern regime for large and medium business, is there not an equally strong case for doing so for small business? While it is true that many small businesses have no foreign operations or income, to the extent that they do (or aspire to have such operations and income) it is not clear why they should be subject to a credit system that 'is inevitably less straightforward … than dividend exemption'. The prospect of being taxed here and abroad may well inhibit small businesses from expanding abroad, introducing a distortion to investment and a disincentive for small firms to develop foreign operations.

The fact that small business involves less complex structures does not suggest that the exemption system and a CC regime (with appropriate modifications) should be more complex, less certain or involve greater administrative costs than it would for medium and large business or in comparison with a credit system. If it is the government's objective that the tax system should not distort commercial decisions, it must have the same objective for smaller businesses, especially those that may consider expanding abroad.

What are the likely revenue implications?

This is a difficult question to answer, in part because there are no publicly available official estimates of the UK corporation tax collected on foreign-source income (net of tax credits) and partly because a switch to exemption would affect revenue through changes in company behaviour that are hard to predict.

The proposed system may provide increased scope for income shifting through transfer pricing and through manipulation of royalty payments (those resulting from licensed use of an asset, generally an intellectual property right). Due to the asymmetric taxation of dividends and royalties, UK parent companies may substitute between the two, and this can lead to potential revenue gains or losses to the UK. Global tax revenue would go down but the net effect on UK tax revenue is in principle ambiguous. It would broadly depend on whether the intangible assets owned by UK multinationals are mainly used in foreign high-tax countries or in foreign low-tax countries. If a move to a dividend exemption system induces UK multinationals to move some of their assets to foreign low-tax jurisdictions, then part of the global revenue loss would be borne by the UK government. The revenue effect would also depend significantly on the scope of the CC regime.

Evidence seems to suggest that the exchequer would not lose a large amount of revenue. Grubert and Mutti (1995) estimated that the average US corporate tax rate on foreign-source income is only 2.7% (like the UK, the US operates a credit system).[8] Since the UK corporate tax rate is lower than that in the US, it seems likely that the UK exchequer also collects very little net tax on the foreign income of UK multinationals. However, this may not represent the limit of the revenue cost of moving to an exemption system. The concern is that taxable income would move offshore.

When looking at countries that operate exemption systems, we do not see any evidence that they collect systematically less revenue from corporate taxes. Table 12.1 shows corporate tax revenue as a share of national income and statutory tax rates for countries that operate some sort of credit system, and for countries that operate exemption systems, either as a general policy or as a policy towards tax treaty partners. This suggests that revenue loss is not a necessary consequence of adopting an exemption system.

[8] H. Grubert and J. Mutti, 'Taxing multinationals in a world with portfolio flows and R&D: is capital export neutrality obsolete?', *International Tax and Public Finance*, 1995, 2(3).

Table 12.1. Corporation tax revenue and statutory tax rate, 2004

Tax treatment of foreign-source dividends	Corporate tax revenue as a % of national income	Statutory tax rate (%)	Deductibility of costs related to tax-exempt foreign dividends	Amount of tax-exempt dividends (%)
Credit system				0
Ireland	3.6	12.5	N/a	0
UK	2.9	30	N/a	0
Greece	3.3	35	N/a	0
Canada	3.5	36	N/a	0
US	2.2	39	N/a	0
Japan	3.6	40	N/a	0
Exemption system				
Switzerland	2.5	25	Yes	100
Norway	10.1	28	No	100
Sweden	3.1	28	Yes	100
Finland	3.6	29	Yes	100
Denmark	3.2	30	Yes	100
Luxembourg	6.1	30	Yes	100
Belgium	3.8	34	Yes	95
Austria	2.3	34	No	100
Netherlands	3.2	35	No	100
Spain	3.5	35	Yes	100
France	2.7	35	Yes	95
Italy	2.9	37	Yes	95
Germany	1.6	38	No interest deduction[a]	95

[a] Full deductibility in the case of the foreign subsidiary not distributing profits.

Source: K-Y. Yoo, 'Corporate taxation of foreign direct investment income 1991–2001', OECD Economics Department Working Paper 365, 2003.

The revenue effects of a switch to exemption depend critically on a number of specific design features of any new system, including the rules for allocation of overhead and interest expenses between domestic income and foreign exempt income. The difficulty occurs in determining the extent to which such expenses are the result of spending that generates foreign income. It is not clear that relief should be given for these expenses since the resulting income would no longer be taxed in the UK. The interest relief rules outlined above set out to restrict the extent to which interest payments on debt that is used to finance overseas investments can be deducted against profits in computing UK corporation tax liability and in doing so seem to be a legitimate attempt to protect the UK tax base.

An exemption system is beneficial provided it does not reduce domestic tax revenue raised from domestic economic activity. A move to exemption can be expected to trigger an increase in outbound investment, since UK companies can then benefit from lower corporate tax rates abroad. However, it might also be the case that we see an increase in domestic investment – for example, if the previous system gave firms an incentive to relocate in other countries. Moving to an exemption system would be beneficial if the latter outweighed the former. Desai and Hines argue that for the US, increased outbound foreign direct investment (FDI) will indeed typically be offset to a very large extent by additional inbound investment.[9] They point out that the bulk of global FDI takes the form of acquisitions of existing firms rather than new greenfield investment. Thus most cross-border FDI seems to involve a reshuffling of global ownership patterns rather than involving a net transfer of saving from one country to another.

The discussion document states that the aim is to make the package of policy reforms broadly revenue-neutral. While we do not take issue with the desire to devise a revenue-neutral package of measures, it appears to us that this objective has obscured the policy goals that underlie the proposals. Thus, in its outline of the CC system, the Treasury leaves the impression that its aim in adopting an exemption system is not to reform the taxation of foreign income as such, but to replicate the current imperfect credit system in a different form. In the Treasury's mind, aiming for 'revenue neutrality' seems to be presented as aiming to achieve the same result with a new regime as with the current one, even though the new regime is based on different economic principles. We think that this is neither sensible nor desirable.

12.6 Conclusions

A move from the current foreign tax credit system to a dividend exemption system should increase the after-tax profitability of UK multinationals by removing the disadvantage that they face relative to multinationals in other countries with exemption systems in the market for corporate control of firms located in foreign low-tax countries. A move to exemption would also eliminate the tax distortion to repatriation decisions generated by the current system of credit with deferral and move towards capital ownership neutrality. In practice, how important these changes are depends in large part on the extent to which the current credit system is effectively an exemption system because of the ability to defer tax payments.

With regard to the details of the policy, the proposed package appears to be handicapped by being designed to replicate an imperfect credit system by exempting some foreign dividends and moving from a CFC to a CC regime, rather than seeking real reform with a satisfactory policy underpinning. Actual exemption replaces effective exemption; foreign profits taxed under the current entity-based CFC regime are to continue to be taxed under an income-based CC regime; compliance with EU law would be secure by extending the CC regime to domestic transactions; and the system of interest relief would continue to subsidise foreign investment subject to some modest tightening of the rules.

At the very least, it seems quite implausible that the measures would produce any real simplification in the system. In particular, given that the income-based CC regime (i) seems to have greater scope than the current entity-based CFC regime, (ii) extends to domestic situations and (iii) requires detailed enquiry into the sources of a company's profits rather than the nature of the company itself, it is difficult to conclude either that it is administratively simpler or that it would be revenue-neutral rather than revenue-raising. At the same time, the tightening of the existing interest deduction rules and the introduction of new interest

[9] M. Desai and J. Hines, 'Evaluating international tax reform', *National Tax Journal*, 2003, 56: 487–502.

restriction rules adds a further layer of anti-avoidance provision to the plethora of anti-avoidance measures targeted at financing costs.

We support the government's aims of producing 'a more straightforward regime for taxing foreign profits' and supporting large and medium business 'by simplifying and modernising the current regime for foreign dividends'. But overall we are not persuaded that the package would achieve such aims. If one of the main advantages of the exemption system is its simplicity then it is important that a package of proposed reforms preserves that.