

Taxing Corporate Income

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Corporate tax policy amounts to choosing the appropriate tax base and the desired tax rate. At the time of the 1978 Meade report, the UK economy was still relatively closed. Hence, there was little concern about how corporate tax policy could cause an international relocation of company residence, real investment or reported profits. In this environment, the Meade report proposed corporate tax base definitions that amounted to taxing economic rents. By effectively allowing a full expensing of capital expenditures, the tax system would not distort the marginal investment decision. In the absence of international tax interdependence, a relatively high tax rate could apply to this base. In the twenty-first century, companies and their profits have become far more internationally mobile. This prompts a re-evaluation of the appropriate corporate tax base as well as the rate.

In an integrated world, each country has to face the choice whether to tax corporate income on a residence basis or on a source basis. With residence-based taxation, capital income, say in the form of dividends, is taxed in the country where the parent company of a multinational firm resides or where the ultimate private or institutional shareholders reside. With source-based taxation, capital income is instead taxed in the country where it is generated. In their paper, Auerbach, Devereux and Simpson argue that residence-based taxation is difficult to maintain in an internationally integrated economy. First, it is difficult to maintain residence-based taxation of corporate shareholders, as such taxation – to the extent that it leads to international double taxation of corporate income – can be avoided by a movement of the firm's tax residence abroad. Second, taxing the income of ultimate shareholders is equally cumbersome, as it is hard for the tax authority to obtain information on the foreign dividend and capital gains income of domestic residents. Given these problems with residence-based taxation, countries are increasingly left to tax corporate income at source.

Auerbach, Devereux and Simpson review the appropriate definition of the tax base in this environment from the perspective of UK national tax policy. While the UK to a large extent retains autonomy over its corporate tax base definition, it at the same time is a member state of the European Union. As such, the UK is subject to the existing body of EU tax directives and other forms of EU tax policy, and it is likely to be important in shaping future EU policy. Depending on one's view, one can see European tax policy as a constraint on UK policy or as a way to improve Europe's tax system by means not available to individual member states. Evidence for the latter

view comes from the fact that European capital income tax policy as a generalization brings back elements of residence-based taxation in EU tax policies through its various Directives. At the same time, it aims to promote an ‘orderly’, non-discriminatory residence-based tax system, as evidenced by pronouncements of the European Court of Justice (ECJ) on capital income taxation. In my comments below, I will summarize the main elements of EU capital income tax policy affecting the UK and other EU member states.

As indicated, the internationalization of the economy also affects the appropriate tax rate. As Auerbach, Devereux and Simpson point out, tax policy makers have to be aware that in an open economy a single tax rate can affect an entire sequence of decisions by corporations that in the end affect the profits that are reported in the countries where the firm operates. The tax rate first potentially affects the countries where the firm operates. The average tax rate, as affected by the headline tax rate, is especially relevant in this regard. Second, the organization form taken by a multinational firm, and in particular the international location of its parent company and subsidiaries, can be expected to be affected by the international tax system. In this regard, firms are interested in avoiding international double taxation where they can. The UK has a system of worldwide taxation, which in itself makes it less attractive as a location of company headquarters in the form of the parent firm. Third, the firm has to decide on the allocation of real productive assets among its establishments in different countries. This choice is affected by marginal tax rates. Next, the overall financing of the firm is affected by the tax system. Given the deductibility of interest expenses, the firm is interested in located its debt in high-tax countries. Finally, the firm can engage in the international shifting of accounting profits so as to report fewer profits in high-tax countries.

In this environment, it is important to know how the tax rate affects each of the various decisions made by the firm that ultimately affect reported profits and hence tax liabilities. Knowledge about these issues ultimately has to come from empirical research. Auerbach, Devereux and Simpson summarize important parts of the relevant empirical literature. However, much of the literature they review is for U.S. rather than European firms. For instance, they review evidence on the relationships between capital structure and organizational forms on the one hand and taxation on the other hand for US firms. UK firms, however, make a main share of their investments in Europe and continental European firms are of course key investors in the UK. Hence,

evidence on tax sensitivities for European firms should also be relevant for the case of the UK. In the final part of my comments, I will review some recent evidence on tax sensitivities in the open economy based on European data to help shape the view on how sensitive profits are to tax policy in today's Europe.

The role of EU tax policy in shaping UK tax policy

The EU Treaties do not call for the alignment of direct taxes such as the corporate income tax, as direct tax policy differences are not deemed to directly affect the proper functioning of the common market. Moreover, as a matter of principle the Treaty of Maastricht does not rule out internationally discriminatory tax practices. Specifically, Article 58, paragraph 1, allows Member States to 'distinguish between tax payers who are not in same situation with respect to their place of residence or with regard to the place where their capital is invested'. However, the scope for discrimination is limited by paragraph 3 of the same Article of the Maastricht Treaty that proscribes 'arbitrary discrimination'. As a further potential restriction on national capital income tax policies, the Treaty of Maastricht elevates the free movement of capital to treaty level.

Going beyond the treaty, the EU can adopt directives in the area of capital income taxation that would be directly binding in all member states. The requirement of unanimity among member states, however, has proven to be an important barrier to the adoption of EU tax directives. As a result, to date relatively few directives in the area of corporate income taxation have been adopted in the EU. In the relative absence of such directives, the European Court of Justice has taken on a heightened role as an arbiter on whether national tax policies are consistent with EU treaties. The lack of explicit legislative action has further prompted the EU commission to try to use 'suasion' to nudge national tax policies in a direction it favors.

What has been the effect of EU tax policies on tax policy in individual member states such as the UK so far? The various extant bits of EU tax policy importantly bear on the main issue of what is the appropriate tax base in an open economy. As indicated, economic openness appears to move the tax system towards a more source-based system. The overall impact of EU tax policy appears to be to slow down and in some instances to reverse this trend, thereby strengthening elements of residence-

based taxation. At the same time, EU tax policy seems to work towards a relatively non-discriminatory, residence-based tax system.

To support this view, we next review some main elements of EU capital income tax policy to date. To start with directives, the Parent-Subsidiary Directive of 1990 eliminates non-resident withholding taxes on dividend payments among related businesses in different member states. The elimination of withholding taxes on intra-firm dividend payments applies, if the parent owns at least 25 percent of the stock of a foreign subsidiary. In 2003, the European Council adopted a revision of the Parent-Subsidiary Directive that extended its application in several ways. Specifically, the directive was to apply to a wider range of companies (to include, for instance, companies that have the newly created legal form of a “European Company”) and it reduces the required minimum shareholding rate of the parent company gradually from 25 to 10 percent. Analogously to the Parent-Subsidiary Directive, the Interest and Royalties Directive of 2003 eliminates non-resident withholding taxes on intra-firm interest and royalty payments. Non-resident withholding taxes are source-based taxes and hence both directives effectively cut back the scope of source-based capital income taxation in the EU.

Along similar lines, the Merger Directive, also adopted in 1990, eliminates the taxation of capital gains realized by corporations and shareholders at the occasion of an intra-EU merger or acquisition. Such capital gains taxes can be seen as deferred taxes on income generated at source in the target country, even if they only apply to resident companies and shareholders. In 2005, a revision of the Merger Directive was adopted to extend its scope.

The EU Savings Directive of 2005 embodies the international exchange of information on cross-border interest accruing to individuals as the main principle to enable residence-based taxation of such income in the EU. Three EU member states, Austria, Belgium and Luxembourg are allowed to levy source-based non-resident withholding taxes on interest instead, but only on a temporary basis till 2010. The Savings Directive covers bank interest as well as interest on government and corporate bonds, except some grandfathered issues. To enable exchange of information, financial institutions have to keep track of the nationality of bank and other interest recipients. This represents a substantial administrative burden for EU financial institutions. The EU Savings Directive thus materially affects the UK, which is the home to Europe’s major financial centre. At present, the Directive does not

cover dividends. Hence, the Directive provides some scope for arbitrage between interest and dividend income streams. If this proves to be important, it may make sense to expand the scope of the Directive in the future to include dividends.

With only a limited coverage of EU tax directives, decisions of the European Court of Justice take on a heightened importance in shaping tax policy in the EU. The court has made decisions with wider ramifications in the area of dividend taxation of individual as well as corporate shareholders. Affecting individual shareholders, the ECJ's judgement in the Verkooijen case of 2000 concerns the taxation of inbound dividends as part of portfolio income. The Netherlands at the time exempted the first 1000 guilders of dividends from personal income taxation, but the exemption only applied to domestic dividends. The Court ruled that this did not conform with the EC Treaty, and that the exemption should apply to foreign inbound dividends as well. Generally, this ruling is taken to imply that personal income tax systems should not discriminate against inbound dividend income.

In the corporate tax area, the Court similarly has ruled in several instances that residence-based taxation of corporate shareholders should not afford a more favourable tax treatment to income from domestic subsidiaries than from foreign subsidiaries. In a case involving the United Kingdom, the ECJ ruled in 2005 in the *Mark & Spencer's* case that this company's foreign losses could be offset against the company's UK profits, if these losses can not be used in another Member State against realized or future profits. The Court thus ruled against the UK's "group relief" legislation that previously had prevented UK companies from offsetting foreign losses against UK profits. Pursuant to the ECJ decision, foreign losses can be claimed, even if the foreign subsidiary has never paid any dividends to the UK parent. Thus, this ruling opens the possibility that the residence-based taxation of foreign-source corporate income generates negative tax revenues in the UK and elsewhere.

In the *Lankhorst-Hohort* case of 2000, the ECJ addressed German thin capitalization rules that limit the tax deductibility of interest payments by subsidiaries to their parent companies. In the German case, these thin capitalization rules only applied to interest paid by subsidiaries paid to their non-German, non-resident parent companies. The ECJ ruled that this violates non-discrimination principles as laid down in the freedom of establishment provision in the EC Treaty. This ruling has had far-reaching implications for thin capitalization policies throughout Europe. The

United Kingdom, which has had a thin capitalization rule since 1988, saw itself forced to extend its thin capitalization rule to apply to domestic subsidiaries also in 2004.

In 2004, the European Commission (2003) published a communication that analyses the implications of case law of the ECJ for the international taxation of dividend income. Regarding outbound dividend payments, an implication appears to be that it is illegal to levy a higher withholding tax on dividends accruing to foreign shareholders than to domestic shareholders. Regarding inbound dividend payments, countries with imputation systems - providing their residents with tax credits for corporate taxes paid by domestic companies - equally have to provide credits for corporation taxes paid by foreign companies. Thus if the UK had retained its previous imputation system, it would be liable to pay tax credits for corporation taxes paid by firms in countries with potentially much higher corporate tax rates than the UK such as Germany. This may be a reason that the UK has abolished its imputation system.

In a non-legislative effort to limit harmful tax competition, EU member states agreed on a code of conduct regarding corporate income taxation in 1997. The code aims to protect the corporate tax base of member states and to bring about a fair international division of that base. It outlines several criteria to identify harmful tax competition. Harmful measures, for instance, may involve relatively low taxes that are ring-fenced in the sense that they are available only to non-residents or apply only to activities undertaken by non-residents. Other harmful measures are those that potentially shift the tax base without affecting the location of real activity. To identify harmful tax practices in the EU, in 1998 Ecofin established the Code of Conduct Group, chaired by the British Paymaster-General Dawn Primarolo. In 1999, this group published its report, which enumerated 66 harmful tax measures. Sweden and the United Kingdom interestingly were the only two countries that were not found to have harmful corporate tax practices. Hence, the restrictions on corporate tax policy laid out in the Code of Conduct do not appear to limit UK corporate tax policy.

The behaviour of international firms and UK tax policy

As Auerbach, Devereux and Simpson outline, firms in open economies face a sequence of choices as to the location of production, physical investment, and the allocation of profits. In addition, the firm has to decide on its debt-equity ratio and, if it has foreign establishments, on the international assignment of its debts. Finally, the

firm has to decide on its organizational form. In an open economy, this involves the location of its headquarters and consequently of its tax residence. Each of these choices is potentially affected by the tax rate and other aspects of the tax system. For tax policy, it is important to know how sensitive each of the firm's decisions is to the tax rate and other parts of the tax system. Estimates of tax sensitivities can be obtained by empirical research. To inform the UK tax debate, ideally such estimates stem from the investigation of European data. Much evidence as reviewed by Auerbach, Devereux and Simpson – for instance, on the debt-equity ratio and organizational form – instead has been based on U.S. data. In the remainder, I will discuss some recent studies on company choice and taxation in open economies with an emphasis on European studies.

Desai and Hines (2002) examine the role of taxation in so-called corporate inversions. In these dealings, the corporate structure is inverted in the sense that the previous U.S. parent becomes a subsidiary of one of its earlier foreign subsidiaries. These inversions serve to eliminate U.S. worldwide income taxation of all previous foreign subsidiaries. In fact, international double taxation is avoided (not counting U.S. dividend withholding taxes) if the new parent resides in a country with a territorial tax system. Examining multinationals newly created through international mergers and acquisitions (M&As), Huizinga and Voget (2007) similarly find that the parent-subsidiary structure reflects international double taxation. Using their estimation results, Huizinga and Voget simulate how the change in a country's tax rate affects the proportion of M&As that select that country as the parent country. On average, an increase in the corporate tax rate by one percentage point reduces the proportion of firms taking up tax residence in a country by 0.36 percentage points. For the United Kingdom, the impact of a one percentage point increase in its tax rate on the proportion of multinationals taking up residence in the U.K. is estimated to be relatively large at 0.53 percentage points, reflecting the U.K. system of worldwide taxation.

De Mooij and Nicodème (2006) examine the relationship between incorporation and tax rates with European data. The impact of tax rates on incorporation is significant and large and it implies that the revenue effects of lower corporate tax rates partly show up in lower personal tax revenues rather than lower corporate tax revenues. This form of income shifting is found to have raised the corporate tax-to-GDP ratio by some 0.2 percentage points since the early 1990s.

Auerbach, Devereux and Simpson mention that foreign ownership of companies may be a reason why corporate taxes have not declined much. Foreign ownership implies that part of the incidence of corporate taxation, in so far as there are rents, is on the foreign owners. They show that the percentage of shares listed in the UK and owned by foreigners has increased from around 5 percent at the time of the Meade report to around 30 percent in 2004. Can the current degree of foreign ownership in the UK explain the relatively low UK corporate tax burden relative to other European countries? Huizinga and Nicodème (2006) consider a measure of the corporate tax burden based on tax payments as a share of assets. Their evidence, relating foreign ownership shares of subsidiaries to average tax burdens for a set of European countries, suggests that this is indeed the case. Figure 1 summarizes their data. The figure shows that there is an overall positive relationship between the foreign ownership share of corporate assets and the average tax burden. The foreign ownership share for the UK is seen to be relatively low at 10.3 percent, while the tax burden is also relatively low at 2.4 percent. Hence, the relatively low degree of foreign ownership in the UK can in part explain a relatively low tax burden. At present, there still is considerable room for foreign ownership to increase in the UK to levels already seen in many other European countries. This could imply upward pressure on the corporate tax level in the UK in the future.

Next, there are a few studies of the extent of international profit shifting by European firms. Using sectoral data in OECD countries, Bartelsman and Beetsma (2003) find that value added reported is negatively related to statutory tax rates. Their estimation suggests that at the margin more than 65% of the additional revenue from a unilateral tax increase is lost due to a decrease in the reported income tax base. Huizinga and Laeven (2007) investigate profit shifting by European multinationals using firm-level data on the location of the parent firm and of foreign subsidiaries from the Amadeus database. They find an average elasticity of the reported tax base with respect to the statutory tax rate of 0.45, while the corresponding elasticity is estimated to be somewhat smaller at 0.30 for the UK. This relatively small elasticity reflects the fact that the UK levies corporate income tax on a worldwide basis, which implies that a change in the UK top corporate tax rate will not affect the incentive to shift profits between a UK parent and a foreign subsidiary in a country with a lower top corporate tax rate such as Ireland. The paper goes on to simulate the impact of profit shifting on national tax revenues. The UK is estimated to be a net gainer on

account of profit shifting within Europe, as its tax rate of 30 percent is lower than the tax rates in many European countries with an average of 34.4% in 1999.

Also using data from Amadeus, Huizinga, Laeven and Nicodème (2007) investigate how the financial structure of European multinational firms depends on the international tax system. Their modelling distinguishes between a ‘domestic’ effect of taxation on leverage and an ‘international’ or debt-shifting effect. The ‘domestic’ effect is the increase in leverage that would occur on account of higher taxation for purely domestic firms. The ‘international’ effect is the additional debt shifting effect that occurs for multinational firms on account of international tax rate differences. For domestic, stand-alone firms, the estimation implies that a 10 percentage points increase in the overall tax rate (reflecting corporate income taxes and non-resident dividend withholding taxes) increases the ratio of liabilities to assets by 1.8 percentage points, which is a rather small effect compared to the sample standard deviation of this leverage ratio of 21 percentage points. For multinational firms, the leverage ratio is more sensitive to taxation on account of international debt shifting. To illustrate this, one can take the example of a multinational with two equal-sized establishments in two separate countries. A 10 percentage points overall tax increase in one country is then found to increase the leverage ratio in that country by 2.4 percentage points, while the ratio in the other country decreases by 0.6 percentage points.

Parent companies in the UK on average have a liability ratio of 0.57, which is less than the average of 0.62 for the entire sample of parent firms in Europe, while foreign subsidiaries in the UK have a leverage ratio of 0.62 on average just equal to the European average. On the whole, subsidiaries located in the UK are found to have an incentive to shift debt out of the UK, which reflects the UK’s relatively low tax rate in the EU.

Conclusion

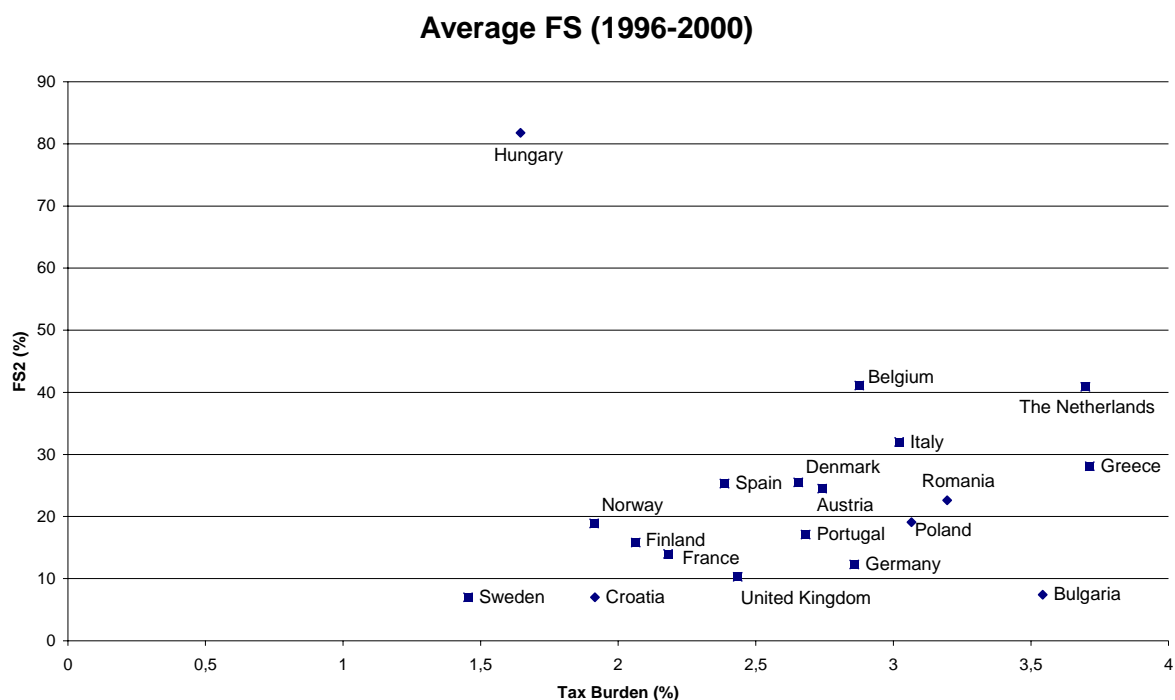
International economic integration makes it more difficult for the U.K. to operate a residence-based corporate tax system with a reasonably high corporate tax rate. Two developments, however, potentially restrict the ‘degradation’ of the corporate income tax system. First, European tax policies tend to work towards maintaining or restoring residence-based capital income taxation. Second, increased foreign ownership in the U.K. and elsewhere prevents a ‘race to the bottom’ in corporate income tax rates. In the future, deeper economic integration may

render it increasingly difficult to raise significant corporate tax revenues. In that instance, further European tax policy cooperation may be called for to enable the U.K. to implement an effective corporation tax.

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Figure 1. The tax burden and foreign ownership



Note: FS2 is the average country-level foreign ownership share over the years 1996-2000, where the country-level foreign ownership share in each year is the asset-weighted average of foreign ownership shares for firms in that country.

Tax Burden is the average country-level tax burden over the years 1996-2000, where the country-level tax burden in each year is the asset-weighted average of tax burdens for firms in that country, and the tax burden for each firm measures corporate tax as a percent of assets.

Source: Huizinga and Nicodème (2006).