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Business and tax: the relationship between UK multinationals and double income tax, 1914-1939

Ryo Izawa

PhD student at Kyoto University; Post Graduate Visiting researcher at University of Glasgow

1. Introduction

Recently, media have extensively reported on tax avoidance of multinationals through using different national tax systems. In July 2013, the Organisation for Economic Co-operation and Development (OECD) published the project report Action Plan on Base Erosion and Profit Shifting. A key aim of this report focused on stopping multinationals from shifting profits across borders to avoid paying tax on corporate profits. Thus, it appears that the relationship between multinationals and international taxation on business income became a public concern at least after the financial crisis in 2007.

While the media unveiled the tax planning of multinationals such as Apple, researchers and some journalists revealed that structural basis of the contemporary international taxation problem originated in the interwar period, pointing out that modern multinationals use the system nurtured for 100 years. As the OECD's report highlighted, it has been recognised at least the 1920s that the interaction of domestic tax systems can lead to double taxation. International standards have sought to address these frictions, but gaps remain**.** On the contrary, the interaction of different tax rules can lead to double non-taxation or less than single taxation (OECD 2013). Moreover, Palan et al. (2010) claimed that most of the familiar instruments of tax havens emerged until the 1920s.

On the other hand, although Piciotto (1992) stated since the First World War that the international interaction of tax systems has been recognized as an important element in international finance and investment, it remains unclear how multinationals in the interwar period executed tax planning under the business situation. Some business historians took up the relationship between multinationals and international taxation on business income when they described company history. However, concrete cases were not collected or analysed in terms of the relationship between multinationals and international taxation. This paper sheds light on the history of the impact of the relationship between multinationals and international taxation on business income in the interwar period and clarifies the behaviour of multinationals confronted with the business environment. Faced with such a regime, did multinationals in the interwar period executed engage in tax planning? If so, how did multinationals execute such tax planning? This study would help to understand depth of the today's international taxation problem as well as impact on business of tax on business.

This paper deals with UK multinationals and the double income tax problem because the UK had the largest stock of outward FDI in the world between 1914 and 1938 (Jones 2005, pp. 21-22). Focussing on UK multinationals and the international taxation problem from 1914 to 1939 can elucidate the impact of the relationship between multinationals and international taxation upon business income. In addition, the problem of international double taxation on business income was called double income tax problem in the UK at that time. This paper then deals with UK multinationals and double income tax problem.

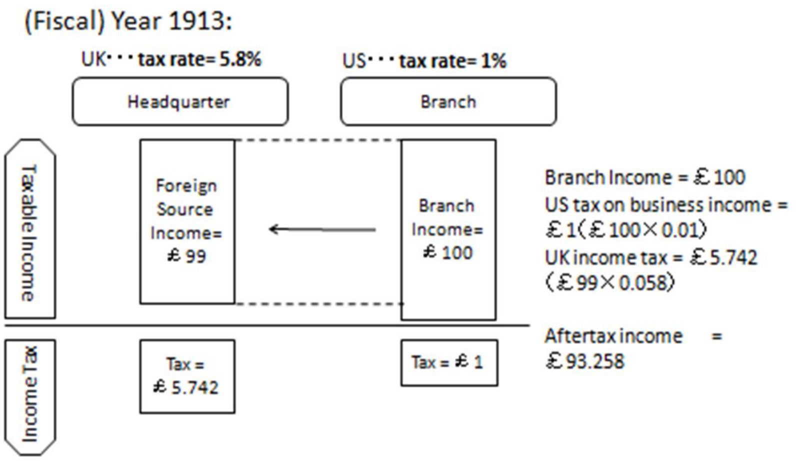
First, I provide a brief overview of international taxation regime in which UK multinationals in the interwar period operated. Then, I explore the effect of the business situation upon UK multinationals and show the case studies by using secondary company history books and unpublished materials. Some brief conclusions follow in the final section.

2. Business situation

The problem of double income tax in the UK became illicit and aggregated mainly because income tax rates all over the world as well as in UK increased from after the outbreak of the First World War. More specifically, in the case of the UK, income tax surged from 5.8% in

1913 to 30% in 1918, then stayed at a much higher level than before the war.[1] As Figure 1 shows, in 1913, a UK multinational which was resident in UK but had a branch in US was obligated to pay US tax (1%) on its US profit of ￡100 and UK tax (5.8%) on ￡99.[2] However, by 1920, such a UK multinational was forced to pay a US tax of 10% on its ￡100 profit and UK income tax of 30% on its ￡90 foreign income. Having said that, this situation was restricted to outside the British Empire. Thanks to the foreign income tax credit system towards the Empire introduced by the Finance Act 1920, UK multinationals having a branch in the British Empire received a tax credit of up to half the rate of UK income tax. Figure 2 illustrates that in 1920, a UK multinational having a branch in Australia was obligated to pay Australian income tax (20%) on its profit of ￡100 and reduced UK income tax (15%) on its profit of ￡100. Additionally, if a US subsidiary was regarded as real controlled from the UK, the UK multinational had to pay pay UK income tax and tax of the overseas country. Namely, if a subsidiary held a board meeting in the UK, the UK tax authority treated it as the branch. (Peden 2000; Picciotto 1992; Seed and Rawlinson 1925; Taylor 2003).

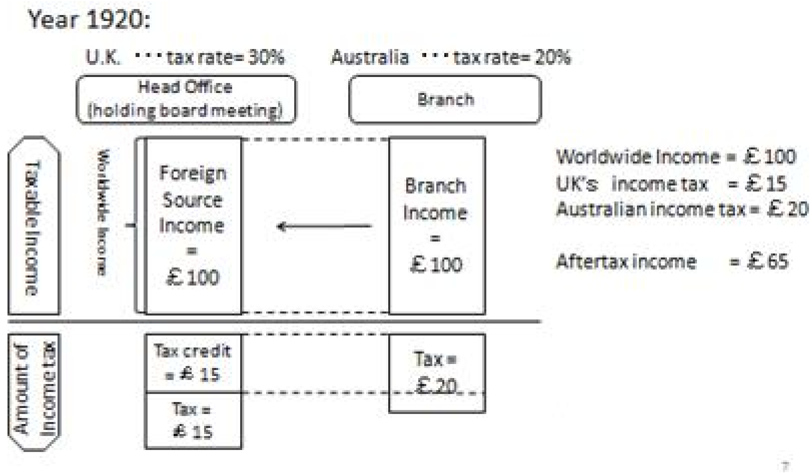
Figure 1. Double income tax between UK and US in 1913



(Sources) Peden, G. C., *The Treasury and British Public Policy 1906-1959*, Oxford University, 2000, p.45; Taylor, J., "Corporation Income Tax Brackets and Rates, 1909-2002", *IRS, Statistics of Income Bulletin*, 2003, p. 287

[1] The income tax rate was 25% in 1922, 20% in 1925, 22.5% in 1930 and 25% in 1935 (Peden 2000).
[2] This paper only uses federal tax to avoid confusion. Australian income tax also was simplified.

Figure 2. Double income tax relief within the British Empire in 1920



Source: Seed, H. E. and A. W. Rawlinson, *Double Income Tax Relief*, PITMAN, 1925, pp.2-5.

The differential foreign tax credit system was established in 1920 as a result of a compromise between the Inland Revenue and various employers' organisations. One year prior to this system's introduction, a Royal Commission on Income Tax took up the double income tax problem as one of its major issues. The draft which the final report on the Commission suggested were applied to the Finance Act 1920 without virtual dispute in parliament.[3] However, there was a conflicting point of view in the Commission. On the one hand, not a small number of witnesses in the Commission on the behalf of their companies or their employers' organisations required not only amending temporary Empire relief in 1916,[4] but also introducing a worldwide tax credit system such as the system that existed in US to provide unlimited as well as world-first foreign tax credit in 1918. On the other hand, Inland

[3] John Butcher, M. P. for York asked why a relief toward outside Empire was lack in budget proposals on 29 Apr. 1920. However, Stanley Baldwin, Financial Secretary to the Treasury replied "The Royal Commission does not recommend any change in the existing situation as to double taxation, so far as foreign States are concerned". On the discussion on the finance bill, although a delegate of The Association to Protest against the Duplication of Income Tax within the Empire was called, he only proclaimed amending the relief within Empire (HC Deb 29 April 1920 vol 128 cc1416-7, HC Deb 07 July 1920 vol 131 cc1562-71).

[4] The finance act in 1916 provided relief up to 7.5%. For example, let A's income earned Dominion be £100, UK rate be 25% and Dominion rate be 15%. In the case of 1916 relief, aftertax income = $(1 - 0.175) \times (100 - 100 \times 0.15) =$ £70.125 (Report of the Royal Commission on Income Tax 1920, pp.16-17, 169).

Revenue consistently resisted introducing worldwide relief because it resisted giving up tax revenue.[5] As a result, the Commission partially acceded to the demands made by the employers' organisations, only accepting the plan of amending relief within the Empire. Such a move meant that the Commission was also able to simultaneously fulfil the Inland Revenue's demands (Minutes of Evidence, Royal Commission on Income Tax 1920; Report of the Royal Commission on Income Tax 1920; Records of Inland Revenue 1919).

The relief system established as a result of this process did not fundamentally change until 1945, when a tax treaty between UK and US was signed. Nevertheless, some employers' organisations, such as the Federation of British Industries, pressed for amending the relief in 1920, which continued to offer a lack of relief towards foreign countries as well as limiting relief to a maximum half credit. One of the main reasons for leaving the system unchanged in 1920 was the reluctance of the UK government authority to cut a source of revenue. Incidentally, when compared internationally, the UK's experience in the interwar period can be considered unique because it applied relief differently between members of the Empire and other countries, and was reluctant to conclude bilateral tax treaties. On the other hand, nearly all countries in the interwar period failed to provide adequate measures to prevent international double taxation on business income, with which multinationals located in those countries did not always satisfy. For example, even the US abolished the unlimited tax credit in 1921, restricting allowable tax credit to an amount equivalent to the US tax rate on all foreign-source taxable income.[6] The reason was to prevent the erosion of tax revenue as well. Although the double taxation problem was a major issue confronted by the Leagues of Nations in the 1920s, the institution also could not fundamentally solve the problem (Records of

[5] The cost of the Double income tax relief toward Empire was estimated at ￡4,000,000.It meant that the expenditure doubled temporal relief in 1916, the cost of which was ￡2,000,000. Inland Revenue estimated a world-wide relief at ￡6,000,000 (Minutes of Evidence, Royal Commission on Income Tax 1920, Appendix No.60; Report of the Royal Commission on Income Tax 1920, Appendix No.1).

[6] France did not charge tax on profits made abroad. However, double taxation on business tax occurred when the foreign profits were brought back to France. Germany also had an international double taxation problem because it chose the resident principle (Picciotto 1992, pp. 10-12).

Federation of British Industries 1929-1931; Davis 1985; Farquet 2012; Picciotto 1992).

Section 2 explained the international taxation problem that occurred during the First World War. As a result, the UK tax authority provided foreign tax credit, which was considered with UK's budget. However, this tax relief could not satisfy UK multinationals in terms of two points: the lack of relief outside the Empire and the limitation placed upon the amount of credit. Thus, UK multinationals, which wanted to keep or obtain what is multinational, were encouraged to adapt to the unprecedented situation.

3. Case studies

This section introduces the case studies on effect of double income tax on UK multinationals by using secondary materials. In addition, it presents a detailed case study on a UK big multinational, Imperial Continental Gas Association, by using archival records as well as unpublished materials.

As I mentioned, although the scholarly research which regarded relationship multinationals and double income tax as main subject has not been done before, some books on company history wrote down the effect. The important works out of such previous studies are Wilson (1954a, 1954b), Reader (1970, 1975) and Wilkins and Hill (1964). According to Wilson, Unilever chose a dual structure to avoid double income tax. The business was controlled by two holding companies, one registered in London and one in the Netherlands with the identical boards of directors and Equalisation Agreement (Wilson 1954a p. ｘⅵ; Wilson 1954b, p. 307). [7] Reader recorded the history of Brunner, Mond, which was one of former Imperial Chemical Industries (ICI). The Brunner, Mond converted branch offices into local subsidiaries to exempt the profits of Brunner, Mond's overseas subsidiaries from British taxation (Australia, 1924; China,1920; India,1922; Japan,1920). To avoid British taxation, these

[7] The dual structure of Unilever emulated the Van den Bergh, which was a constituent of Unilever and took up the structure by 1922 to avoid double income tax (Wilson 1954b, pp. 233, 307).

subsidiaries also needed to be regarded as independent entities including having local boards of directors who really could independently run their companies. On the other hand, although one of the parent company's directors wanted the subsidiaries to act their own responsibility, the subsidiaries "could hardly avoid regarding themselves, inwardly, as branch managers" even in the era of ICI. Converting into local subsidiaries did not always mean that the local subsidiaries became self-reliant (Reader 1970, pp.335, 337; Reader 1975, p.200). Following Wilkins and Hill, in 1930, Ford motor company Ltd. (British Ford) set up a holding company in Luxembourg, which acquired English company's stock in six of the continental subsidiaries and accumulated dividends (Wilkins, pp. 196-197). Although the ultimate purpose of this scheme was to avoid double income tax, the reason why the company chose Luxembourg would be to utilise its character as a tax haven.[8] Similarly, Courtauld used Lichtenstein holding companies and Rio Tinto founded a Swiss holding company, all to avoid double income tax on these European businesses (Coleman 1969, p.280; Harvey 1981, p.214). Switzerland and Lichtenstein also offered holding company regimes such as Luxembourg.[9]

The secondary materials examined for this study reveal that these UK multinationals reorganised their financial structures to avoid double income tax. Subsequently, I follow a more detailed case study on a UK multinational not researched academically, clarifying the corporate behaviour to avoid double income tax.

The Imperial Continental Gas Association (ICGA) was a big business as well as a gas and electricity provider for Continental Europe. Its market value was £9.24 million in 1930, comparable to that of Tate & Lyle, the 36th largest UK companies in 1930 by market value of shares (Bourne-Paterson 1970; Chandler 1994, Appendix B.2). In addition, the company had a

[8] The 1929 holding company regime in Luxemberg charged the company an annual registration tax of 0.2% of its equity. The company was not liable to any other type of tax, either on income received or distributed (EP services, "1929 holding companies", http://www.epservices.com/1929-holding-companies.html, accessed 24 Feb. 2014)
[9] More precisely, Liechtenstein, Luxembourg and Monaco introduced laws allowing Swiss-style holding companies (Farquet 2012, p.16).

character of so-called freestanding company, partially because the revenue from UK only accounted for approximately 15% in 1930.

According to a statement from a company meeting in 1931, the ICGA regarded itself as “one of the most unfortunate victims of double taxation”. This view was based on the fact that “the Belgian taxation authorities deduct 22 percent from the gross amounts of our dividends and the British authorities 22 1/2 per cent from the remainder”. For that reason, the company in the meeting reported that it took two measures to alleviate double income tax. First, the ICGA stated that it used “The Utility Loan Company, which is the channel through which we finance our associated companies for the very good reason that by so doing we avoid a large part of the foreign taxation which would otherwise be borne by us”. Second, the company reported that the company’s best interests lay in “not to press the subsidiary companies for dividends in excess of the sum required to yield a reasonable rate of dividend”. Furthermore, the ICGA said that “reserves will be created in the subsidiary companies”.[10]

To explain the first measures in detail, ICGA established a private company in 1927 to avoid double income tax. The name was the Utility Loan Company (ULC), which loaned Belgian subsidiaries as its name suggests. This arrangement reflected the fact that Belgian authorities charged tax at the reduced rate of 5% on interest paid to a foreign company. The Belgian authority regarded a company that had neither an office nor permanent establishment in Belgium as a foreign company. Accordingly, the ULC was set up to fulfil these criteria, which ICGA Co. itself could not fulfil. Figure 3 (p.10) illustrates the above mechanism by using the tax rate in 1931. At first, the ICGA loaned money to the ULC (Arrow①) and then the ULC re-loaned the money to the Belgian subsidiaries (Arrow②). When interest on the loan was came back to the ULC, interest was imposed on only 5% of Belgian interest tax (Arrow③). This allowed ICGA to save taxation at a rate of 17% because the money invested the Belgian companies (Arrow

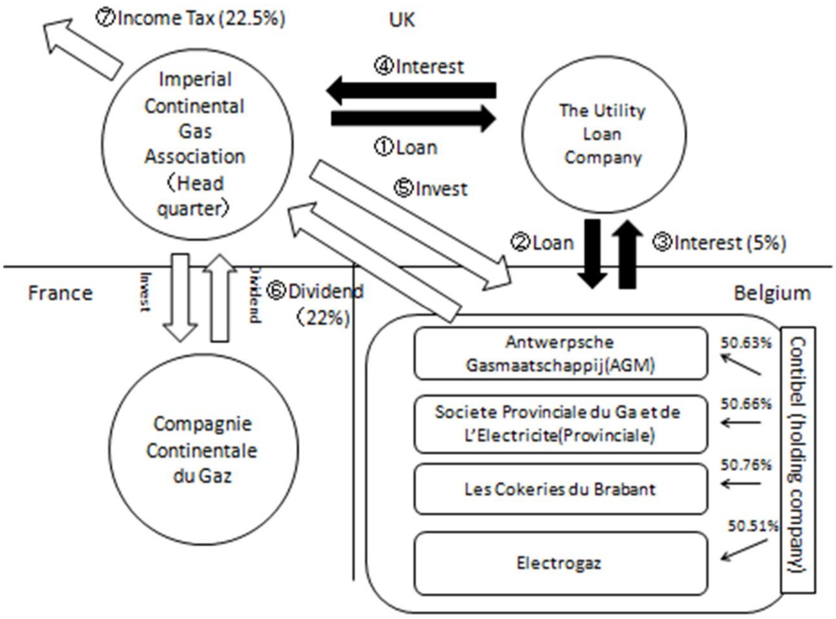
[10] Imperial Continental Gas Association, Proceedings at the 183rd Ordinary General Meeting of the Proprietors of the Association, pp. 11, 16-18. in CLC/B/122/MS23344/005: Circulars to shareholders. Include annual reports and accounts for the years 1931-1936, London Metropolitan Archives.

⑤) faced the 22% of Belgian dividend tax (Arrow⑥). Then, the ICGA received interest revenue from ULC without paying tax on it (Arrow④) and paid a 22.5% income tax on net profits (Arrow ⑦). As Table 1 (p.10) shows, interest revenue from the Belgium business burgeoned from 1928. In 1927, when ULC revenue was not reflected, interest revenue from Belgium was only ￡518. However, this amount increased to ￡13,824 in 1928. The percentage of Belgian total revenue was approximately 25% at its peak in 1933, when interest revenue was ￡101,941. ICGA created a financial subsidiary only to utilise the difference between dividend tax and interest tax rates (Bourne-Paterson 1970).

The second measure related to converting branch offices in Belgium into Belgian subsidiaries. Double income tax was caused by the remitted dividends from overseas subsidiaries, meaning that double income tax did not occur when subsidiaries did not remit their profits. On the other hand, UK authorities imposed UK income tax on the profit of overseas branches whether they remitted or not. Therefore, if ICGA converted the branches into subsidiaries, the company could reserve its profit in Belgium easily. The company executed such conversion in 1929. As shown in Table 1, revenue of Belgian branches sharply decreased in 1930 because the conversion accomplished. Alternatively, dividend revenue comprised majority of total Belgian revenue. In addition, the company gave up stockpiling profit in UK after 1933. The amount of after-tax profit was nearly the same as the amount of dividends remitted to ICGA shareholders. This indicates that subsidiaries stockpiled their profit in their own areas. The amount placed in reserve during 1936-1940 was Frs. 67,759,225 (approximately ￡500,000). Considering that French revenue was from a dividend of a French holding company, Compagnie Continentale du Gaz[11] and UK revenue was also generated from dividends from other companies' shares, the corporate structure of ICGA became similar to pure holding company.

[11] Compagnie Continentale du Gaz was established in 1909 to be regarded as not English company (Anon 1974 p.22).

Figure 3. Business organisation of ICGA, 1933 (※tax rate was that in 1931)



(Sources) Anon, *The Imperial Continental Gas Association , 1824-1974*, 1974, p.30.; ICGA, Report of the directors and statement of accounts 1936 in CLC/B/122/MS23344/005, Records of Imperial Continental Gas Association, London Metropolitan Archives

Table 1. Financial results of ICGA, 1926-1934 (£)

	1926(Dec)	1927(Dec)	1928(Dec)	1930(Mar)	1931(Mar)	1932(Mar)	1933(Mar)	1934(Mar)
Belgium Revenue								
Branch Profits	235,139	323,315	376,409	22,887	30,591	36,128	40,953	43,372
Dividend (mainly from subsidiaries)	254	352	429	186,942	202,657	187,121	192,450	229,147
Interest(≒ULC)	13	518	13,824	31,707	66,007	84,868	101,941	70,639
Others	9,362	2,018	4,487	143,111	111,536	75,026	52,301	63,183
Total	244,768	326,203	395,149	384,647	410,791	383,143	387,645	406,341
France Revenue								
Dividend	59,796	68,529	79,981	147,503	196,508	223,030	208,359	221,900
Interest	79	55	32	0	0	0	0	0
Total	59,875	68,584	80,013	147,503	196,508	223,030	208,359	221,900
UK Revenue(≒dividend)	85,706	81,407	84,769	105,610	129,218	92,741	67,744	37,590
Other areas	18,108	22,932	35,267	25,190	19,114	22,470	85,192	68,971
Total Revenue	408,457	499,126	595,198	662,950	755,631	721,384	748,940	734,802
Total Charge	198,545	217,735	101,888	83,103	59,398	54,466	68,324	75,913
UK taxation	60,699	64,224	106,051	111,609	144,149	164,918	169,618	144,619
Aftertax net Profit	149,213	217,167	387,259	468,238	552,084	502,000	510,998	514,270
Dividend	158,080	158,080	237,120	270,465	433,464	451,500	504,000	513,800
Reserve	0	0	70,000	70,000	0	0	0	0
Participating Bous	0	0	2,371	2,705	4,335	4,515	5,040	0
Carry Forward	-8,807	59,087	77,768	125,068	114,285	45,985	1,958	470

(Source) Bourne-Paterson, R. A., *The Imperial Continental Gas Association in the twentieth century* [Unpublished typescript], London Guildhall Archives, 1970, Appendix 3a.1.

In 1933, a Belgian holding company was established. It could convert loss of a subsidiary into a holding company account to save the tax. And the division of Belgium of the ICGA became more autonomous. According to a book on the company's history, "it [turning into local companies] brought difficulties in communication and inevitably weakened the tight control that London office had exercised over the various activities of the Association in pre-war days" (Anonymous 1974, p.29). In the case of ICGA, the double income tax problem led to creation of a financial subsidiary only to avoid taxation, and helped the subsidiary to become self-reliant.

The cases of UK multinationals presented in this section clarify that UK multinationals began to utilise overseas subsidiaries to avoid double income tax. The effect upon management of converting into subsidiaries were mixed, as Brunner, Mond/ ICI retained strong control, in contrast to ICGA, which lost control from the headquarter. However, a common thread in all the cases must be the fact that overseas subsidiaries stockpiled their overseas profit to avoid double income tax. And tax planning of these companies such as accumulation of overseas profit, application of holding companies in European small countries or use of the differential tax on equity capital and debt capital (thin capitalisation) are virtually identical to contemporary multinationals' tax planning.[12]

[12] For example, tax planning by Apple included using Ireland as a home for a subsidiary and place to accumulate their overseas profit (USA Today, "How Apple's phantom taxes hide billions in profit", http://usatoday30.usatoday.com/tech/news/story/2012-07-23/apple-phantom-taxes/56441134/1; Forbes, "How Does Apple Avoid Taxes?", http://www.forbes.com/sites/leesheppard/2013/05/28/how-does-apple-avoid-taxes/, accessed on 24 Feb. 2014). Amazon UK used Luxembourg-based holding company to avoid UK taxation (The Guardian, "Amazon, Google and Starbucks accused of diverting UK profits", http://www.theguardian.com/business/2012/nov/12/amazon-google-starbucks-diverting-uk-profits accessed on 24 Feb. 2014). OECD's Action Plan on Base Erosion and Profit Shifting in 2013 took up thin capitalisation to solve matter (PWC, "OECD's Action Plan on Base Erosion and Profit Shifting (BEPS) – A Brave New World?", http://www.pwc.com/sg/en/tax-bulletin/assets/taxbulletin20130730.pdf accessed on 24 Feb. 2014).

4. Conclusion

The problem of double income tax, which emerged when income tax rates everywhere had increased since First World War and stayed at a much higher level than before the War, caused the UK to introduce the British Empire double income tax relief in 1920. However, the content of the relief was not sufficient to UK multinationals. Some big UK multinationals, if not all UK multinationals, faced with double income tax executed tax planning such as reorganisation of business entities, use of tax havens or financial subsidiaries to utilize thin capitalization. UK multinationals during the examined period could serve as a prototype of today's tax planning. Additionally, given that countries other than the UK faced more or less similar situations, multinationals in the interwar period would execute tax planning as today's multinationals do.

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