Taxation of corporate income: Some European approaches

The corporation income tax has long been a subject of dispute in the United States as well as in other countries Controversy here can be expected to grow in the next several months after President Carter presents his tax reform proposals to the Congress. It is likely that special attention will be focused on the problem of the double taxation of corporate dividends: dividends are now taxed once when the corporation pays taxes on its total profits, then again when stockholders pay taxes on the dividends they receive. Double taxation not only raises a question of equity, but the important economic question of whether double taxation has a major adverse effect on capital investment In light of these concerns, it seems worthwhile to review how the double taxation problem is handled in the revenue systems of other developed countries.

There are two basic approaches to the corporate income tax. One—essentially that in force in the United States—is to tax income as each separate economic unit receives it (the "separate entity" or "classical" system) If this principle of taxation is considered legitimate, it in effect denies that there are grounds for criticizing double taxation

The other approach is the one in force in most industrial countries It works to combine the corporate and individual income tax so that any double taxation of dividends is either fully or partially eliminated (the "integrated" system) This is accomplished through a split rate arrangement or through an imputation (dividend credit) arrangement. The split rate method takes the form of a lower corporate income tax rate on distributed profits than the rate on retained profits. Under the imputation method, a variety of techniques are used to allocate or credit to the shareholder some or all of the tax the corporation pays on distributed profits In general, the shareholder adds his gross, *i.e*, pretax, dividends to his other income He computes his taxes at the rate applicable to his income bracket and then deducts the credit he receives for part or all of the taxes the corporation pays on the profits that have been distributed to him

In recent years, industrial countries abroad generally have moved toward imputation Countries that are now using one or another form of it include Canada, France, Germany, Japan, and the United Kingdom. Fiscal experts believe that an imputation system makes investment in corporate stock more attractive than either a separate entity or a split rate tax system does.

This article is confined to describing corporate taxation in three European countries—France, Germany, and the United Kingdom. Their basic corporate tax systems are quite similar: all three countries utilize a credit or imputation mechanism to provide tax relief on dividend distributions to corporate shareholders There are, however, several important differences (A summary of the main features of corporate taxation in the three countries is presented in the table)

After the corporate tax systems of the three coun-

Corporate Taxation in France, the Federal Republic of Germany, and the United Kingdom, 1976-77

Main features	France	Germany	United Kingdom
General provisions			
Basic structure	Dividend credit*	Mixed: split rate† and dividend credit*	Dividend credit*
Corporation tax rate	50 percent	Retained· 56 percent Distributed· 36 percent	52 percent
Dividend credit on net dividends	50 percent	56 3 percent	49.3 percent
General treatment of intercorporate dividends	Participation exemption (with 10 percent or more ownership)	Same treatment as other shareholders	Exempt
International provisions			
Jurisdiction	Territorial	Global	Global
Resident corporations			
Subsidiary dividends	Exempt; equalization tax on redistributions which may be reduced under some treaties	Taxed except where exempt by treaties, foreign tax credit	Taxed; foreign tax credit, ACT‡ on redistributions, not reduced by foreign tax credit
Branch profits	Exempt, equalization tax on redistributions	Taxed, foreign tax credit	Taxed; foreign tax credit, ACT‡ on redistributions, not reduced by foreign tax credit
Portfolio investment dividends	Taxed, foreign tax credit, dividend credit available for redistributions	Taxed, foreign tax credit, lower rate on distributions	Taxed, foreign tax credit, ACT‡ on redistributions, not reduced by foreign withholding tax
Nonresident corporations			
Subsidiary dividends	Corporation tax plus withholding tax of 25 percent (reduced under many treaties), no dividend credit	Corporation tax plus withholding tax of 25 percent, no dividend credit at present	ACT‡; no withholding tax, generally no dividend credit
Branch profits	Corporation tax plus withholding tax of 25 percent on distributions (reduced under some treaties); no dividend credit	Corporation tax of 50 percent plus withholding tax of 25 percent, no dividend credit	Corporation tax, no withholding tax; no dividend credit
Portfolio investment dividends	Corporation tax plus withholding tax of 25 percent (reduced or eliminated under most treaties), dividend credit to many countries under treaties	Corporation tax plus withholding tax of 25 percent (reduced under some treaties), no dividend credit at present	ACT‡, no withholding tax; dividend credit to some countries under treaties

* Imputation or dividend credit system = allocation, or imputation, to the shareholder of credit for some or all of the corporation tax on distributed profits

† Split rate system = a lower corporate income tax rate on distributed profits than on retained (or undistributed) profits.

‡ ACT = advance corporation tax (United Kingdom)

Source: Compiled from various national and international publications tries are outlined, some of the international ramifications of these systems will be explored. Particular features of a country's corporate tax system may have significant consequences for international capital flows, insofar as tax considerations govern the relative advantages of investing at home or abroad and the extent to which investment funds from abroad are attracted.

France

France abandoned the separate entity tax system in 1965. At that time it introduced integration at the shareholder level by means of an imputation mechanism. French corporations usually pay a 50 percent tax on profits realized on their operations in continental France. French residents (both individuals and corporate shareholders) who own less than 10 percent of a company's shares receive a credit against their own income tax of 50 percent of the dividends they receive. This arrangement is called the *avoir fiscal, i.e.,* dividend credit. It is worth noting that there is no withholding tax on domestically earned dividends paid to residents.

Domestic intercorporate dividends are exempt from the corporation tax if the "parent" holds 10 percent or more of the shares of the "subsidiary". When the dividends received from the subsidiaries are paid out to the shareholders of the parent corporation and the corporation tax has been paid, the dividend credit becomes applicable.

Dividend distributions from corporate profits that are taxed at less than 50 percent or are not taxed at all—such as dividends emanating from operations abroad—are subject to a compensatory or equalization tax *(précompte mobilier)* at the corporate level. The rate of the *précompte mobilier* is the same as that of the *avoir fiscal.* Since the basic French corporation tax is territorial in nature, *i.e.,* it applies only to income earned domestically, an equalization tax is deemed necessary on income arising from foreign sources The *précompte mobilier* is also due on dividends arising out of domestic profits that were realized more than five years ago, even if such profits were fully taxed This provision is designed to induce corporations not to defer distributions too long.

Initially, the French imputation system denied the dividend credit to nonresident shareholders, but subsequently, through bilateral treaty arrangements, it was made available to many foreign portfolio investors but not to French subsidiaries of foreign corporations. All dividends paid to nonresident shareholders are, as a rule, subject to a 25 percent withholding tax at the source, but this rate has been reduced in most of the treaty arrangements, or even eliminated for some portfolio investors

French branches of foreign corporations are liable for the French corporation tax and, after deduction of the corporation tax, a branch profits withholding tax at the rate of 25 percent. The withholding tax is, however, often lowered by tax treaties. In addition, the withholding tax on profits distributed to French residents, through head offices abroad, is wholly refundable.

Germany

Effective January 1, 1977, Germany moved from a split rate system to a mixed system that combines features of the split rate and the dividend credit systems. Thus, the new German tax arrangement provides relief at both the corporation and shareholder levels. The worldwide income of German corporations is subject to a 56 percent tax (formerly 52.53 percent) if retained and to 36 percent (formerly 15.45 percent) if distributed. This lower tax rate on distributed profits than on retained profits—the split rate element—provides relief at the corporate level and is one of the main distinguishing features of the new German system *vis-à-vis* the imputation systems used in France and the United Kingdom. On the dividend side, resident shareholders are entitled to a tax credit that is equivalent to their prorated share of the income tax paid by the distributing corporation. There is a 25 percent withholding tax at the source on dividend payments, which is later offset against the income tax liability of resident taxpayers.

Intercorporate dividends of resident corporations are treated in essentially the same manner as dividends received by resident individuals. Specifically, such dividends plus the amount of taxes paid on them must be included in the taxable income of the receiving corporation In turn, that corporation is entitled to a credit for the taxes already paid on those dividends. Unlike French corporations, German corporations also pay taxes on income earned in foreign countries However, German corporations receive a tax credit for foreign income taxes paid by their subsidiaries abroad except where treaty arrangements exclude foreign source dividends from taxable income.[1]

Dividend distributions to nonresident shareholders (individual or corporate) do not give rise to any tax credit for the corporation taxes paid. Furthermore, nonresidents generally are not entitled to any refund of the 25 percent withholding tax on distributed dividends. Thus, the new tax system effectively discriminates against nonresident shareholders since they are not entitled to the same tax relief available to residents.

[1] A special relationship known as *organschaft* between resident corporations permits profits and losses of a resident subsidiary to be offset by the parent corporation if the parent corporation owns more than 50 percent of the subsidiary, and if the latter operates as though it has "no will of its own"

The German government is expected to renegotiate treaty arrangements with many countries regarding the withholding tax. It is probable that the new treaties will alleviate a part of the extra tax burden on nonresidents

German branches of foreign corporations are taxed at a flat rate of 50 percent (formerly 50.47 percent) on both retained and distributed profits. There is also a 25 percent withholding tax at the source on dividends. Thus, like the French system, the benefits from the new German system are not passed on to branches of foreign corporations.

United Kingdom

In 1965, the United Kingdom (U.K) switched from an imputation system to a separate entity system. In 1973, however, after only eight years of experience with the latter, the U.K readopted the imputation system, although in a substantially different form than before 1965 Under the 1973 tax law, the worldwide income of U.K. corporations (whose management and control is exercised from the U.K.) is taxed at a uniform rate, currently 52 percent.

A unique aspect of the new system is that, unlike those of France and Germany, dividend payments give rise to an advance corporation tax (ACT) Under this system, when a U.K corporation distributes its profits as dividends, it is required to make an advance tax payment at a specified rate. (For the fiscal year 1977-78, this rate is likely to be 33/67, or just under 50 percent.) The corporations are allowed, within limits, to offset the ACT against their own tax liability for the current, or two preceding, or any succeeding periods. Resident shareholders in effect are entitled to treat ACT as a dividend tax credit shareholders gross up, *i.e*, add together dividends received and the advance corporation tax payments, and then apply the ACT as a credit against their tax liability. Intercorporate dividends are exempt from the corporation tax and from the ACT.

In principle, the U K. system seeks to avoid any international double taxation of profits by granting credit for taxes paid abroad The ACT system, however, generally does not allow any tax credit resulting from taxes paid abroad to be offset against the portion of tax (the first 33 percentage points) that is covered by the advance corporation tax This ensures that the dividend credit to the shareholders is paid into the U K. treasury Thus, the ACT formula can erode most of the foreign tax credit.

Dividends paid by the U K corporations to nonresident shareholders involve ACT payments Nonresidents generally are not entitled to a dividend credit with respect to the ACT; however, unlike France and Germany, there is no withholding tax at the source. As in the case of France, several tax treaties (renegotiated since 1973) provide a dividend credit to foreign portfolio investors. The new treaty with the United States, which is not yet in force, will accord a partial relief to parent companies as well.

Both dividends and retained profits of U.K. branches of foreign corporations are taxed at the regular corporate tax rate (52 percent), but there is no withholding tax at the source and no ACT requirement. The tax treatment of branch profits is similar to the treatment in France and Germany since distributed and undistributed earnings are taxed equally. Because there is no withholding tax, however, the effective tax burden on branches is lower in the U K

International implications

There are three major international issues that have arisen in connection with corporate tax policies in France, Germany, and the United Kingdom.[2] The first has to do with discrimination, that is, with any policy that restricts to residents the tax relief resulting from the imputation system and therefore acts to the detriment of nonresidents. The second or neutrality issue is related to another aspect of discrimination. This concerns the tax treatment of investment abroad. The third issue, tax harmonization, is interrelated with the first two. It is exemplified by the tax proposals of the European Economic Community (EEC) that are designed to promote free movement of capital within the Community.

When France, Germany, and the United Kingdom moved to the imputation system, all three initially restricted tax relief to resident shareholders However, as noted above, France and the United Kingdom have already extended tax relief to nonresident portfolio investors under treaty arrangements, and Germany may do the same. This, of course, still leaves most nonresident corporations having direct investments without any dividend credit. In France and the United Kingdom, such discriminatory treatment of nonresidents has been justified on the basis that it minimizes the revenue loss almost always accompanying a switch to the imputation system because of the partial or full relief of a second taxing of dividends Both countries wanted to minimize potential revenue loss; they also wanted to restrict to residents alone the benefits that result from

[2] There are, of course, many important domestic issues at stake, such as the impact of changes in corporation taxes on corporate financing and on capital formation The discussion here is limited to the main international questions Some of the domestic aspects of alternate proposals for corporate tax integration in relation to the United States are taken up in Martin Feldstein and Daniel Frisch, "Corporate Tax Integration The Estimated Effects on Capital Accumulation and Tax Distribution of Two Integration Proposals", *National Tax Journal* (March 1977)

the revenue loss to the government. The revenue loss argument seems to have been somewhat less important in Germany, but the relevance was recognized insofar as the change in the tax system was coupled with increased corporation tax rates.

Another important consideration underlying the discriminatory treatment of nonresidents in all three countries seems to have been the desire to promote investment in common stocks (equities) by residents. The separate entity tax system tends to discourage dividend distributions and to encourage financing through retained earnings over outside financing. Moreover, it tends to favor financing by bonds or loans over equities since interest payments are deductible as a business cost. The split rate system also favors bond financing over equity financing, although to a lesser extent. By contrast, the imputation system tends to put equity and bond financing on a more equal footing. If the dividend credit is restricted to residents only, as is essentially true in the three countries dealt with here, it makes domestic equity investment more attractive. In fact, encouraging equity investments by French residents was one of the primary reasons why France moved from the separate entity to the imputation system in 1965.

Neutrality and taxes

Turning now to the matter of international corporate tax neutrality in relation to investment income from abroad, a tax is considered neutral if it does not alter the taxpayer's choice between investing at home and investing in foreign countries. Under a neutral tax policy, net rates of return and investment decisions are not affected by tax factors because there is no tax burden differential between domestic and foreign investment.[3] (In other words, international tax neutrality requires integration of the foreign corporation tax with the domestic personal income tax.) Neutrality therefore promotes efficient resource allocation on a worldwide basis. As opposed to this "world efficiency" orientation, tax policy may be designed to promote national gains by creating tax differentials which discourage individuals and corporations from investing abroad. The extreme case of nonneutrality is represented by the so-called "national efficiency" criterion that aims at maximizing gains for the nation as a whole. Under this criterion, the gross return (pretax) on domestic investment must equal the net (after foreign taxes) return from foreign investment, assuming no other costs or benefits are associated with foreign investment.

In the United Kingdom, discussions of corporate tax reform concentrated heavily on the issue of tax neutrality between investments at home and abroad by domestic corporations As things turned out, the present imputation system with the ACT tends to discriminate against foreign investment by U K. corporations, especially in high tax countries. However, the tax system also fails to meet the criterion of "national efficiency" because it usually provides larger credits on foreign taxes paid on income earned abroad than would be necessary to equalize the net returns from investment abroad with the gross return on domestic investment.

The question of tax neutrality has not received much attention in France. This is mainly due to the territorial nature of the French tax system It exempts foreign income of French corporations from corporation taxes, whereas the concept of tax neutrality usually assumes that income from abroad is taxed Exempting investment income from abroad is not fully consistent with international tax neutrality unless all countries grant the same exemption The French *précompte* on redistributions from foreign source income is also inconsistent with tax neutrality, because the foreign corporation tax is not integrated with the domestic personal income tax Moreover, as is the case in the United Kingdom, the French tax system does not meet the national efficiency criterion; depending on the foreign corporation tax rate, the net return on foreign investment may be different from the gross return on domestic investment

German taxation of investment income from abroad is somewhat more in line with international tax neutrality than that in France and the United Kingdom. However, several German treaty arrangements that use exemptions and reduced tax rates result in a discriminatory treatment of foreign investment income earned in some countries as compared with others. In some cases, the treaties also lead to less than complete integration of foreign corporation taxes with the domestic personal income tax. In addition, in many cases the foreign tax credits that Germany grants are not equal to the taxes paid, which is also inconsistent with the principle of tax neutrality

Promoting tax harmony

The proposals to harmonize tax systems in the EEC also have had a bearing on tax policy discussions and decisions in France, Germany, and the United Kingdom After considering the split rate and the separate

[3] International tax neutrality may be defined as "capital-export neutrality"—neutrality in the treatment of income from domestic and foreign sources in the capital-exporting country—or as "capital-import neutrality"—neutrality in the treatment of income of investors from different countries that arises in the capital-importing country In the present context, capital-export neutrality is the relevant concept For a detailed analysis of international tax neutrality, see Mitsuo Sato and Richard M Bird, "International Aspects of the Taxation of Corporations and Shareholders", IMF *Staff Papers* (July 1975), and Richard M Bird, "International Aspects of Integration", *National Tax Journal* (September 1975)

entity systems, the EEC recently decided to adopt the dividend credit system as a means of tax harmonization that would achieve and maintain the free flow of capital among member countries. The choice of the imputation system is justified mainly in terms of its neutrality with respect to different types of corporate financing and to various legal forms of business organization, as well as its ability to reduce double taxation of dividends—thereby lessening the comparative disadvantage for small shareholders—and to encourage equity investments by medium-size savers.

In France, the imputation system had been adopted long before the current EEC position was agreed on, partly for some of the same reasons. The U.K. choice of the imputation system was influenced by the EEC, whose position had been well formulated by 1973. Clearly, the adoption of the new tax system in Germany was also influenced by a desire to facilitate the harmonization of corporate tax systems within the EEC.

Although all three countries have imputation systems, it cannot yet be said that there is a free flow of capital among them. This is due not only to the obvious differences among their corporate tax systems, but also to their substantially different economic regulations, for example, the extent and impact of their foreign exchange controls. Thus, even widespread adoption of partial imputation systems is not enough to ensure that the EEC will achieve free movement of capital among its member countries. Apart from harmonizing their regulations, what is required is that taxation of foreign and domestic investment income be made neutral, at least with respect to the Common Market members themselves. While none of the three tax systems currently meet this test, the system recently adopted by Germany meets it better than the systems now used in France and the United Kingdom. Attaining movement of capital free of tax distortions among member countries of the EEC still seems to be distant, inasmuch as the adoption of internationally neutral corporate taxation may involve significant revenue losses as well as considerable administrative and technical difficulties.

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