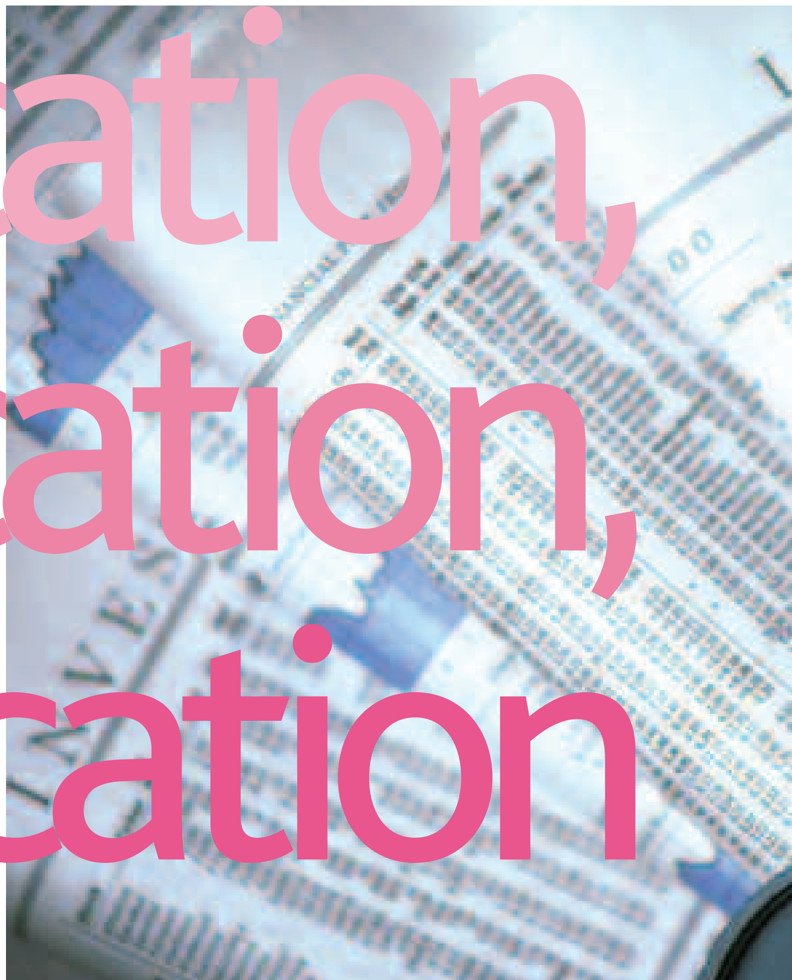
Location, location, location



In *The Wealth of Nations*, Adam Smith listed four key requirements of a good tax system: equity, neutrality, certainty and administrative efficiency. He must have been thinking of a single country otherwise he might have added competitiveness to the list. Certainly, in today's world, countries compete to entice businesses, and sometimes individuals, to their territory.

For an individual, the choice of country to reside in, or be a citizen of, is a deeply personal issue. Indeed, for citizenship some would not regard it as a choice at all. If your family has lived in one country for a millennium, how could you contemplate transferring your allegiance to another?

For companies, however, particularly where directors are fiduciaries over a company belonging to many shareholders, the location decision is, or should be, a matter of unemotional cost/benefit analysis considered on a long-term basis.

The purpose of a commercial business venture carried on by a company is to generate cash for its shareholders, mainly in the form of dividends and occasionally from the onward sale of the company's shares. As illustrated in *Figure 1*, part of the company's revenues must be disbursed as operating expenses, since no company can operate without some combination of employees, premises, third-party suppliers of goods and services, and so forth. However, other significant leakages from corporate revenues are the many taxes that the state levies on the company. Finally, when dividends are paid, the state may levy a withholding tax, and even also charge a further personal tax on the shareholder.

THE TOTAL CONTRIBUTION In this context, it is important to focus not just on taxes on profits (such as corporation tax) but rather on the total tax contribution the company makes to the state. By the way, a good quiz question is to ask for the names of all the taxes to which a UK company is subject! PricewaterhouseCoopers recently conducted a survey for the Hundred Group of Finance Directors, which found that corporation tax accounted for only half their total tax contribution, with the most important other taxes being employers national insurance (20%), business rates (11%) and, especially important in the financial sector, irrecoverable VAT (9%).

When companies are considering location decisions, the different parts of their business will vary in mobility, for example:

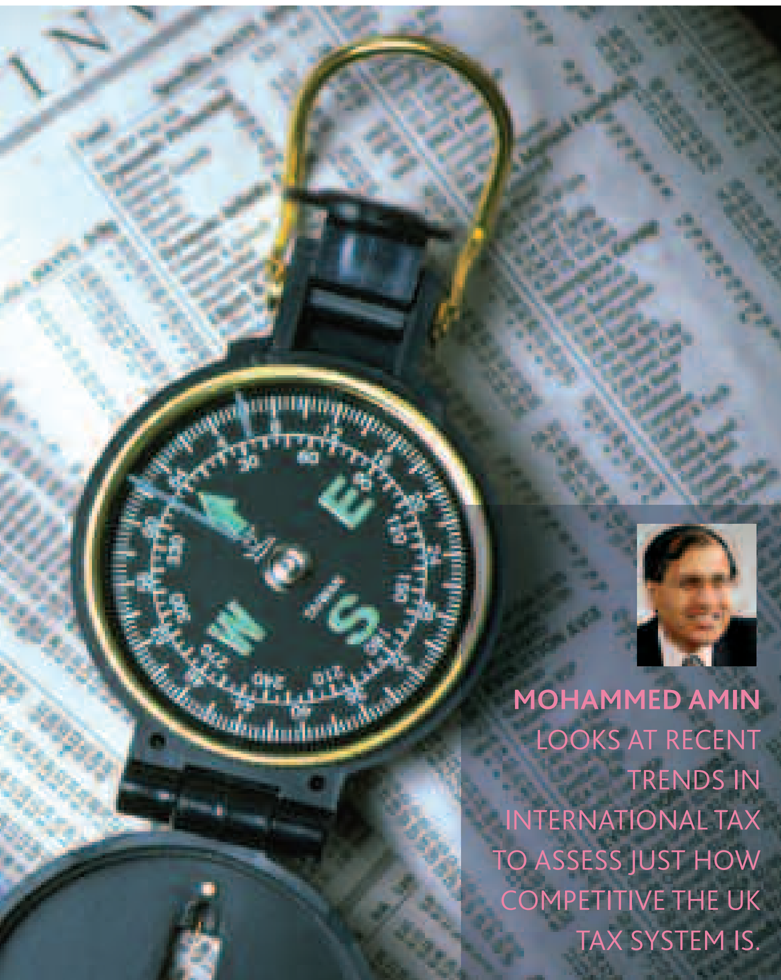
Mines and oil wells. There is clearly no scope to move such facilities to another jurisdiction. However, the issue is quite different when companies are considering new exploration activity, and countries may sometimes find themselves excluded from exploration and development activity, either because the general environment is too hostile (civil war) or because the country seeks to tax too great a proportion of the output.

Executive summary

- Traditionally, the UK has considered it unnecessary to compete in the international game of tax competitiveness to entice both businesses and individuals to stay or relocate here. But a series of drivers could turn the slow leak of tax-driven exiles into a flood. Directors with a fiduciary duty have to look at a range of factors in deciding where best to locate or relocate their business.

Factories. My experience is that location decisions regarding factories are usually determined by factors such as labour supply, cost, and transport logistics. However, taxation factors often enter at a sub-country level – for example, deciding between different cantons in Switzerland or locating in a special economic zone within a particular country.

Offices. While the supply and cost of office staff should be the main determinant, tax can be a decisive factor. For example, several



MOHAMMED AMIN LOOKS AT RECENT TRENDS IN INTERNATIONAL TAX TO ASSESS JUST HOW COMPETITIVE THE UK TAX SYSTEM IS.

multinational companies have located their European shared service centres and international trading companies in Ireland rather than the UK purely because the Irish corporate tax rate is 12.5% compared with 30% for the UK.

Finance companies. A finance company within a multinational group typically has a very large value of intra-group loans managed by a small number of people. While access to banking systems and a congenial environment for the staff are important, location decisions are usually determined by tax factors such as the corporate tax rate, the extent of the country's tax treaty network and the attitude of the country's tax administration.

Holding companies. As with finance companies, a holding company typically employs a small number of people, although for a group parent company these will need to be highly expert individuals. The location decision is usually based on a combination of tax and operational factors. While the holding company does not need to be co-located with its subsidiaries, it must be able to supervise the subsidiaries from its own location – for example, by avoiding excessive time zone differences if most of the subsidiaries are located in one time zone. Similarly, a jurisdiction must be compatible with the location wishes of senior management; for example, the parent company of a Midlands-based engineering group would be unlikely to relocate to the other side of the world if that meant that all the senior management had to emigrate with it. However, as discussed below, relocations do happen.

Against the above theoretical backgrounds, what are the trends in international tax competition? In the rest of this feature, I will focus on four territories: the Netherlands, the US, the UK and Ireland.

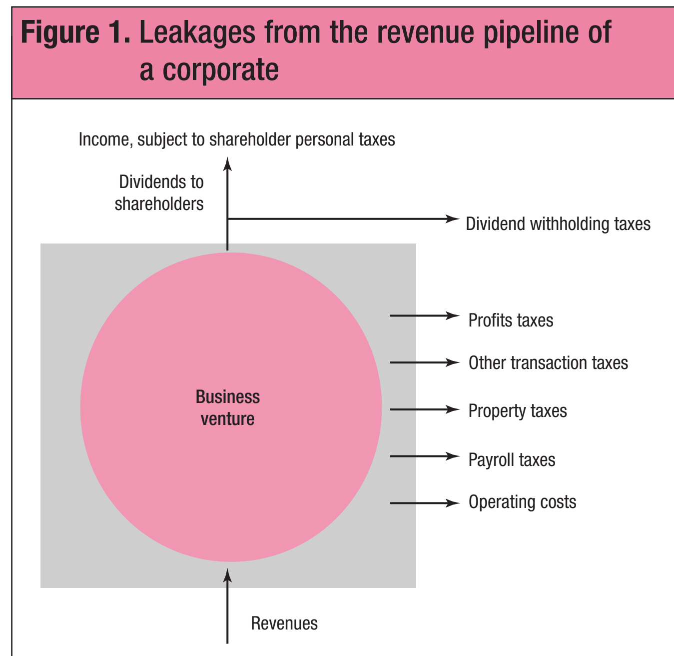
THE NETHERLANDS The country has an extensive treaty network and participation exemption (that is, in general, dividends from overseas subsidiaries and gains from the sale of their shares are not subject to Dutch tax). Accordingly, the Netherlands has always been an attractive place to locate a holding company. Another attraction of the country has been its system of tax rulings, which can provide certainty of tax treatment for transactions whose tax consequences may otherwise be unclear. For example, the Dutch might rule that if a company brings certain activities into the Netherlands, extra tax-deductible amortisation of the market value of its existing intangible assets will be allowed.

THE UNITED STATES Perhaps because of the size of its economy and its once remote geographical location, the US has not historically engaged in tax competition. On the contrary, it has often pioneered tax-policing measures, of which the best example is sub-part F of the tax code, introduced in 1962. In certain circumstances, this directly taxes US parent companies on profits made by their foreign subsidiaries. The UK did not introduce a similar measure until 1984, in the form of the controlled foreign companies legislation.

Starting in the early 1990s, some very large US companies decided that the US had become such a high-tax environment, especially with regard to foreign profits due to rules like sub-part F, or the rules governing the availability of double taxation relief, that they started to relocate abroad.

Initially, this was often linked to a takeover. For example, instead of a large US company issuing shares to buy a smaller foreign target, it would arrange a 'reverse acquisition', whereby the smaller foreign company issued its shares to acquire the larger US company. This left the original shareholders of the larger company in control of what was now a foreign-parented group. However, there was no need for a takeover to enable emigration. It could be achieved by a US company simply creating a new overseas subsidiary, and then having that

Figure 1. Leakages from the revenue pipeline of a corporate



THE US APPROACH OF MAKING EMIGRATION PENALLY EXPENSIVE IS PROBABLY NOT AVAILABLE TO THE UK DUE TO ITS OBLIGATIONS UNDER THE EU TREATIES.

subsidiary issue shares to the public shareholders to acquire the parent, a process known as inversion.

Early in 2002, the US became concerned about the number of large companies emigrating, and introduced penal tax rules to prevent it – so far, successfully.

IRELAND Ireland is one of the best examples of successful tax competition. Initially it gave specific tax exemptions, such as the 10% tax rate in the Dublin Irish financial services sector, which attracted a significant number of jobs, and related financial expertise, to Dublin. Later, when the European Union prohibited such "harmful tax competition", Ireland lowered its main corporate tax rate to 12.5%. As a result, the country has attracted a significant number of internationally mobile operations, with a dramatic beneficial impact on the Irish economy.

THE UNITED KINGDOM Like the US, but unlike the Netherlands and Ireland, the UK has not historically seen any need to engage in international tax competition. A combination of the English language, membership of the EU, relatively low wages (compared with Western Europe), low payroll taxes and flexible labour laws have made the UK a preferred location for inwards investment into Europe.

However, for certain types of activity the UK has been seeing a leakage of jobs to Ireland, driven by the lower Irish corporate tax rate. While such relocations may attract a moderate amount of publicity in the new location as jobs are created, the disappearance of jobs from the UK can be relatively invisible as multinational companies avoid publicising such relocations. Even less visible are those occasions when a multinational deciding where to locate a new European activity chooses a foreign location due to more congenial taxes rather than choosing the UK.

The other trend which has now emerged is for groups to relocate their parent company overseas. So far, this flow is best described as a trickle, with, for example, at least one insurance group relocating to Bermuda. However, the flow is likely to grow unless the UK takes steps to make itself a more attractive location for internationally mobile activities such as group parent companies.

The alternative approach adopted by the US of making emigration penally expensive is probably not available to the UK due to its obligations under the EU treaties. These should preclude the UK implementing tax rules which have the effect of preventing UK companies relocating to other EU countries.

Mohammed Amin is a tax partner at PricewaterhouseCoopers and specialises in the taxation of treasury transactions.
mohammed.amin@uk.pwc.com
pwc.blogs.com/mohammed_amin
pwc.com

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