Business and Economic History On-Line

Vol. 13 2015

The Formation of Companies for Tax Avoidance: The Relationship between UK Multinationals and International Double Taxation in the Interwar Period

Ryo Izawa

The purpose of this study is to explore the rise in the formation of subsidiaries to circumvent international double taxation on business income (double business income tax). It also clarifies how establishment of such companies affected the parent companies. Multinationals started to take tax avoidance seriously when double business income taxation became a heavy burden caused initially by tax hikes during the First World War. This paper draws on archival sources to examine two cases of UK multinationals that engaged in the strategy. First, Imperial Continental Gas Association set up a financial subsidiary to take advantage of a difference between dividend tax and interest tax rates in Belgium. In addition, it also converted branch offices in Belgium into Belgian subsidiaries in 1929. The reason was that the subsidiaries could not only circumvent UK income tax laws but also stockpile their profits in Belgium. These strategies led to difficulties in communication and inevitably weakened the tight control exerted by the firm's London office on the Belgian subsidiary. Second, Unilever chose to create dual parent companies in the UK and the Netherlands in 1929. The company reorganized its corporate structure to maintain the dual headquarters in 1937 and allotted all of the firm's continental European assets to the continental headquarters, fearing that the London headquarters would not be able to monitor the continental headquarters in the event of war.

Introduction

Efforts by multinational to avoid taxes by manipulating national tax systems have attracted global attention in recent years. However, this corporate practice is not well understood because few scholarly works, particularly historical studies, have focused on

Ryo Izawa <ryo-izawa@biwako.shiga-u.ac.jp> is a lecturer in the Faculty of Economics at Shiga University, Japan

URL: http://www.thebhc.org/sites/default/files/Izawa_BEHO_Final%20Draft.pdf

the topic[1]. Furthermore, it appears that business historians and international business theorists have overlooked the impact of tax avoidance on business management. This study explores how avoidance of international double taxation on business income (double business income tax) affected the behaviors of multinationals.

Regarding the relationship between taxes and multinationals, business historians have focused primarily on tariffs rather than double taxation. They identify tariffs as a factor that encouraged multinationals to engage in local production or withdraw from foreign markets.[2] On the other hand, business historians seldom examine double business income taxation. Some business historians have mentioned double business income tax in a broader discussion of political risks.[3] However, even they are likely to regard the tax issue as a matter for host countries. This study follows the relationship between multinationals and double business income taxation by looking at whether the tax issue solely affects host countries.

In international business theory, the effect of double business income taxation on corporate behavior is unclear. International business theorists have exclusively focused on techniques for tax avoidance. The subject of double business income taxation is likely to be categorized as an aspect of financial strategy in textbooks. Tax avoidance techniques such as tax havens, thin capital, and transfer pricing are introduced as immoral but essential tools.[4] However, these theorists have little interest in the impact of the techniques on business management. This study explores whether tax avoidance affected multinational firms' corporate organization. It focuses, in particular, on Bartlett and Ghoshal's typology and selection of business entities.[5]

This study examines the history of the relationship between UK multinationals and double business income taxation in the interwar period. The reason why I chose the subject is that the UK had the largest stock of outward foreign direct investment (FDI) in the world from 1913 to 1943. And the UK multinationals took measures to deal with the problem of double business income taxation, which occurred as income tax rates outside the UK increased after the First World War and remained at a much higher level than before the war.[6]

Moreover, studying the history of the relationship between UK multinationals and international double taxation on business income leads to a better understanding of

---

[1] Palan, R., Murphy, R. and C. Chavagneux, *Tax Havens: How Globalization Really Works* (Ithaca: Cornell University Press, 2010).
[2] Jones, G., *Multinationals and Global Capitalism from the Nineteenth to the Twenty First Century* (New York: Oxford University Press, 2005).
[3] See Wilkins, M., *The History of Foreign Investment in the United States, 1914-1945* (Cambridge: Harvard University Press, 2004); Donzé, P. and T. Kurosawa, "Nestlé coping with Japanese nationalism: Political risk and the strategy of a foreign multinational enterprise in Japan, 1913–45", *Business History 55(8)* (2013).
[4] See Rugman, A. M. and S. Collinson, *International Business sixth edition* (London: Pearson, 2012), pp.497-533; Hill, C. W. L. *International Business: Competing in the Global Marketplace* (Berkshire: McGraw Hill Higher Education, 2014); Hill, 596-618.
[5] Bartlett, C. A. and S. Ghoshal, *Managing Across Borders: The Transnational Solution* (Boston: Harvard Business School Press, 1989).
[6] Jones, *Multinationals and Global Capitalism*, p.22; Jones, J. F. A., 'Sir Josiah Stamp and Double Income Tax', in J. Tiley (eds), Studies in the History of Tax Law, Volume 6 (Oxford: Hart Publishing, 2013), 2-3.

current multinationals' behaviors as well. By comparing past and current corporate behavior, we can identify differences, develop analogies, and examine inheritances.

First, I provide a brief overview of international taxation regimes in which UK multinationals were located during the interwar period. Then I explore the effect of the business situation on UK multinationals and illustrate my case studies by using secondary materials for three of the companies and archival sources for two of the companies. Then I present some brief conclusions in the final section.

1. International tax regimes of the UK

Concerns over double business income taxation grew in the UK as tax rates on business income in the UK and throughout the world increased after the outbreak of the First World War. More specifically, in the UK, income tax surged from 5.8 percent in 1913 to 30 percent in 1918, and then remained at a much higher level than before the war. As Figure 1 shows, in 1913, a UK multinational that was resident in UK but had a branch in the US was obligated to pay US tax (one percent) on its US profit of £100 and UK tax (5.8 percent) on the remaining £99. However, by 1920, such a UK multinational was forced to pay a US tax of 10 percent on its £100 profit and UK income tax of 30 percent on the remaining £90 of foreign income.[7]

This situation only affected multinationals with branches outside the British Empire. Due to the foreign income tax credit system introduced by Article 27 of the Finance Act of 1920, UK multinationals with branches within the British Empire received tax credits of up to half the rate of UK income tax.[8]

Some businesspeople and trade groups advocated for a worldwide tax credit system, such as the system instituted in the US that provided an unlimited foreign tax credit in 1918, a world first. They petitioned the UK government to follow the US's example which had been introduced to prompt US foreign direct investment. However, the British Treasury consistently resisted worldwide relief in order to retain tax revenues until the UK-US tax treaty in 1945.[9]

---

[7] Peden, G. C., *The treasury and British public policy 1906-1959* (New York: Oxford University Press, 2000); Taylor, J., "Corporation Income Tax Brackets and Rates, 1909-2002", *IRS, Statistics of Income Bulletin*, 2003, 287-288.

[8] Seed, H. E. and A. W. Rawlinson, *Double income tax relief* (London: Pitman, 1925), pp.2-5

[9] Picciotto, S., *International business taxation: a study in the internationalization of business regulation* (London: Weidenfeld & Nicolson, 1992), 1-42.

Figure 1. The rate of income tax on business income of the UK and US, 1913-1944

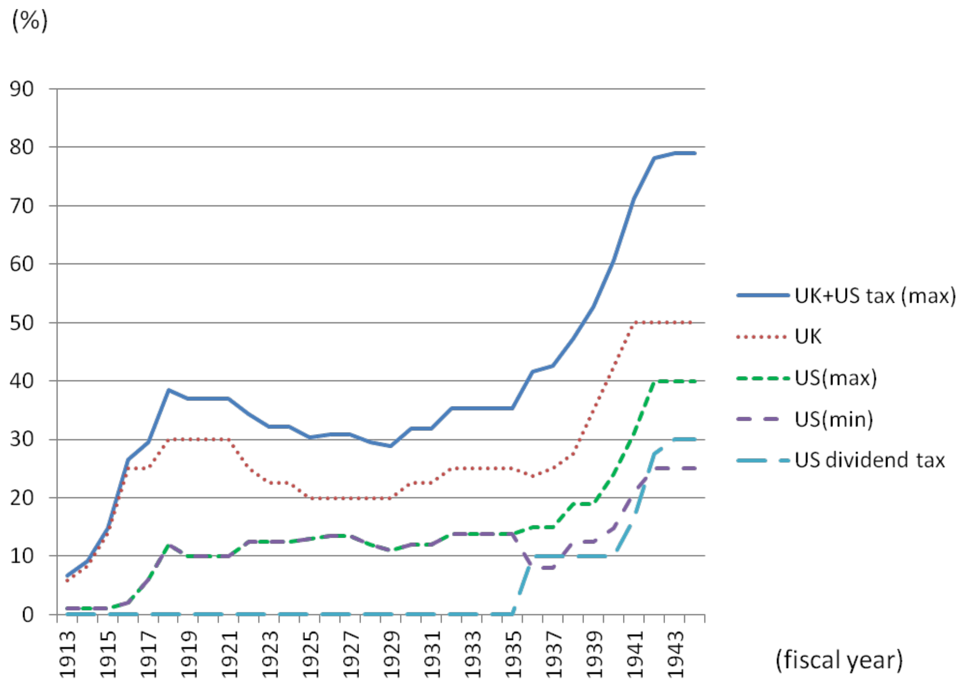
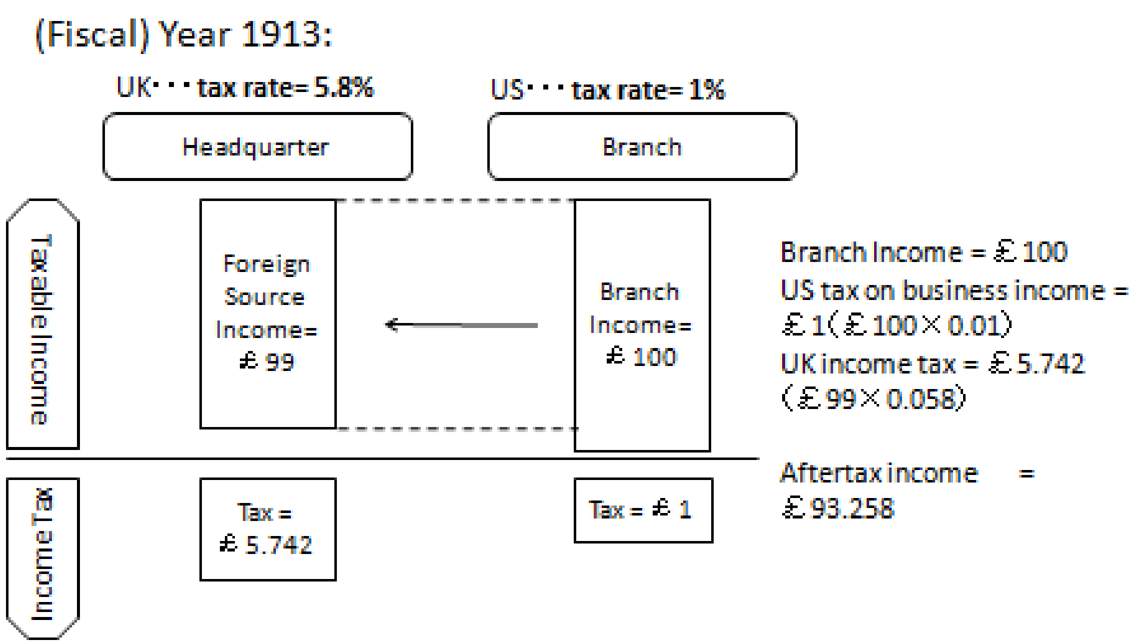
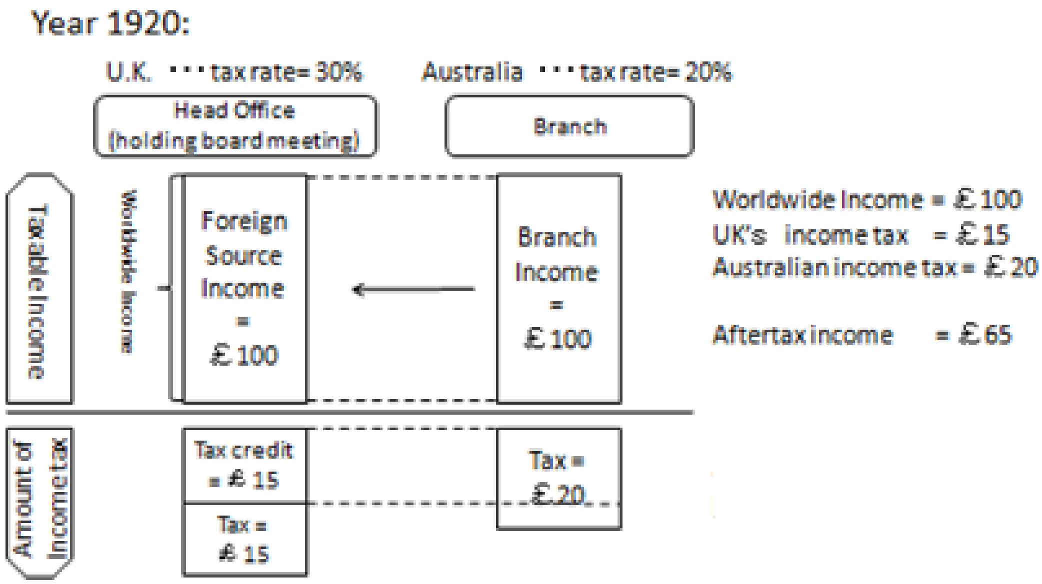


Figure 2. Double business income tax between UK and US in 1913



Sources, Figure 1, 2: Peden, G. C., The Treasury and British Public Policy 1906-1959 (New York: Oxford University Press, 2000), pp. 44, 94,149,207,212,268,287; Taylor, J., Corporation Income Tax Brackets and Rates, 1909-2002, *IRS, Statistics of Income Bulletin*, 2003, pp.287-288.

Figure 3. Double income tax relief within the British Empire in 1920



Source: Seed, H. E. and A. W. Rawlinson, *Double income tax relief* (London: Pitman, 1925), pp.2-5.

2. Case Studies from Secondary Sources: Brunner Mond, British Ford, and Royal Dutch Shell

This section assesses secondary materials in case studies of tax strategies employed by UK multinationals. Although little research has been conducted that focuses on multinational businesses and double business income taxation, company histories recount firms' tax minimization techniques and provide a valuable source. The following three UK multinationals restructured to avoid double business income taxation.

W.J. Reader provides a detailed history of Brunner Mond, formerly a part of Imperial Chemical Industries. He notes that Brunner Mond converted branch offices into local subsidiaries to exempt its overseas businesses from British taxation (China and Japan in 1920, India in 1922, Australia in 1924). To avoid British taxation, these subsidiaries also needed to be regarded as independent entities, including having local boards of directors who would run the firms, or at least appear to run them, independently of the parent company.[10]

According to Wilkins and Hill, in 1930, Ford Motor Company Ltd. (British Ford) set up a holding company in Luxembourg, which acquired the English company's stock in six of its continental subsidiaries and accumulated the dividends.[11] The company chose Luxembourg because it was a tax haven.

Jonker and Zanden, in their history of Royal Dutch Shell, an Anglo-Dutch multinational oil company, wrote that "during and after the First World War, tax became

[10] Reader, W.J., Imperial Chemical Industries: A History, Vol. 1, The Forerunners 1860-1926 (London: Oxford University Press, 1970), 335, 337.

[11] Wilkins, M and Frank Ernest Hill, *American business abroad: Ford on six continents* (Detroit: Wayne State University Press, 1964), 196-197.

an overriding consideration in the administrative organization of the Group." They also wrote that "the spread of income and profit taxation around the world meant that in order to avoid dual taxation the Group had to set up separate companies nearly everywhere." Royal Dutch Shell converted a number of branch offices into subsidiaries in the interwar period (e.g. Asiatic Petroleum Company). In addition, the *Financial Times* reported that "to avoid double taxation the Royal Dutch and the Shell Transport, holding companies, do not draw from their subsidiaries more than is required to pay their own dividend." This enabled the overseas subsidiaries to stockpile their own profits, thus circumventing double business income taxation.[12]

The secondary materials examined for this study reveal that these UK multinationals reorganized their corporate structures to avoid double business income taxation. Through archival sources, I offer a more detailed case study of two UK multinationals who engaged in corporate restructuring to avoid double taxation, and I focus on the impact of double business income taxation on corporate avoidance behaviors.

3. Case Studies from Archival Sources: Imperial Continental Gas Association and Unilever

This section draws upon archival sources to explore how Imperial Continental Gas Association and Unilever acted to circumvent double business income taxation. It recounts the techniques these two companies employed and their consequences for corporate behavior — particularly, corporate organization.

3. (1) Imperial Continental Gas Association —Tax planning Directly Affected the Management

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. In addition, the firm was characterized as a so-called free standing company, partially because the revenue from its UK operations only accounted for approximately 15 percent of its total revenues in 1930.[13]

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 percent from the remainder."[14]

For that reason, company officials in the same meeting reported that the firm took two measures to alleviate double business income taxation. 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 management

---

[12] Jonker, J. and L. Zanden, *From Challenger to Joint Industry Leader, 1890-1939: A History of Royal Dutch Shell, volume 1* (Oxford: Oxford University Presss, 2007), pp. 289, 497; *The Financial Times*, 6 June 1932.

[13] Bourne-Paterson, R. A., *The Imperial Continental Gas Association in the twentieth century* [Unpublished typescript] (London: London Guildhall Archives, 1970).

[14] 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.

reported that the company's best strategy was "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."[15]

ICGA established the Utility Loan Company (ULC) in 1927 to avoid double business income taxation. The private firm provided loans to ICGA's Belgian subsidiaries, as its name suggests. This arrangement reflected the fact that Belgian authorities charged tax at the reduced rate of five percent on interest paid to a foreign company. The Belgian authority regarded a company that had neither offices nor a permanent establishment in Belgium as being a foreign company. Accordingly, the ULC was set up to fulfil these criteria, which ICGA Co. itself could not fulfil. Figure 4 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 came back to the ULC, it was only subject to the five-percent Belgian interest tax (Arrow③). This allowed ICGA to save taxation at a rate of 17 percent because the money invested in the Belgian companies (Arrow⑤) would have otherwise faced the 22 percent Belgian dividend tax (Arrow⑥). Thus, the ICGA received interest revenue from ULC without paying tax on it (Arrow④) and paid a 22.5 percent income tax on net profits (Arrow ⑦). As Table 1 shows, interest revenue from the Belgium business burgeoned from 1928. In 1927, when ULC revenue did not reflect the tax avoidance strategy, interest revenue from Belgium was only ￡518. However, this amount increased to ￡13,824 in 1928. The percentage of total Belgian revenue was approximately 25 percent at its peak in 1933, when interest revenue was ￡101,941. Thus, ICGA created a financial subsidiary in order to take advantage of the difference between dividend tax and interest tax rates.[16]

The second measure ICGA pursued involved converting branch offices in Belgium into Belgian subsidiaries. Double business income taxation was caused by the remitted dividends from overseas subsidiaries, meaning that double business income taxation did not occur when subsidiaries did not remit their profits. On the other hand, UK authorities imposed UK income tax on the profits of overseas branches whether they remitted or not. Therefore, if ICGA converted the branches into subsidiaries, the company could retain its profits in Belgium. The company executed such a conversion in 1929. As shown in Table 1, revenues from the Belgian branches sharply declined in 1930 because of the conversion. Alternatively, dividend revenue comprised the majority of total Belgian revenue. In addition, the company gave up stockpiling profit in the 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 came from a dividend issued by a French holding company, Compagnie Continentale du Gaz[17] and UK revenue was also generated by dividends from other companies' shares, the corporate structure of ICGA became similar to that of a pure holding company.[18]

---

[15] Ibid.

[16] Bourne-Paterson, *The Imperial Continental Gas Association in the twentieth century*, Appendix 3a.1

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

[18] Bourne-Paterson, 232.

Figure 4. Business organisation of ICGA, 1933 (※tax rate was that in 1931)

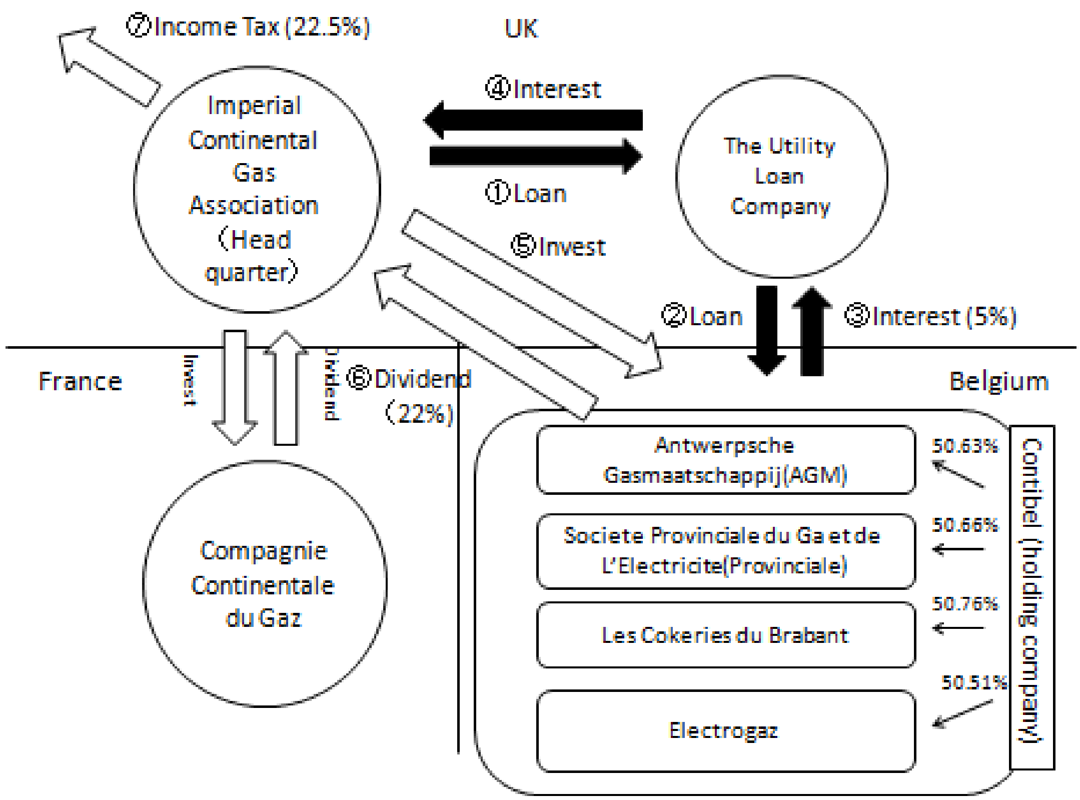


Table 1. Financial results of ICGA, 1926-1934 (£)

	1926(Dec.)	1927(Dec.)	1928(Dec.)	1930(Mar.)	1931(Mar.)	1932(Mar.)	1933(Mar.)	1934(Mar.)
Belgium								
Stations Profits	**235,139**	**323,315**	**376,409**	22,887	30,591	36,128	40,953	43,372
Dividend	254	352	429	**186,942**	**202,657**	**187,121**	**192,450**	**229,147**
Interest	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
Revenue(≒Dividends) from other area	105,312	173,123	200,807	278,366	344,840	344,248	363,300	328,461
Revenue	350,080	499,326	595,956	663,013	755,631	727,391	750,945	734,802
Charge	140,168	217,935	102,646	83,166	59,398	10,473	70,329	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**	**552,000**	**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**

Sources, Figure 4, Table 1: 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; Bourne-Paterson, R. A., *The Imperial Continental Gas Association in the twentieth century* [Unpublished typescript], London Guildhall Archives, 1970, Appendix 3a.1.

Arguably, however, a reshuffling of personnel was the most important consequence of ICGA's reorganization. In Belgium, in December 1930, ICGA created a new position — Liaison Officer for ICGA and its Associated Companies. The appointee, Maurice Perier, executed a long-considered plan to localize ICGA's Belgium division. Belgian subsidiaries ceased receiving directors dispatched by ICGA's London headquarters and gained independence from the parent company.[19]

The reorganization for tax avoidance of ICGA offers a clear example of a UK multinational exploiting the tax policy of Belgium for Inward-FDI. On the other hand, the reorganization weakened the London headquarters' tight control over its Belgian subsidiary.

3. (2) Unilever –Tax planning affected the management indirectly

The most remarkable organizational aspect of Unilever is the dual structure it adopted after its formation in 1929, which followed the cases of Van den Berg. For tax avoidance, Unilever concluded the equalization agreement and located the two headquarters in the UK and Netherland.[20]

The remarkable point of the Unilever case is not only the motivation to apply the dual structure but also the outcome caused by the dual structure. In 1937, Unilever had to reorganize its business structure to implement the equalization agreement. Following the rise of the Nazi regime in Germany, Unilever N.V profits, which had been two-thirds of Unilever's overall profit in 1930, declined to one-third by 1937. When Unilever N.V. allocated the reduced profit to Unilever Limited, it incurred the double business income tax. To alleviate or prevent the problem, Unilever assigned its entire continental European and US business activities to Unilever N.V. The business of Unilever Limited was restricted to within the British Empire.[21]

Following the reorganization of Unilever in 1937 (Figure 5), Unilever's board expressed concern about their loss of control from London in a special committee memorandum. "Subject to the Legal difficulties being overcome, the only disadvantage to the scheme is that if all the Continental Interests are held by Unilever N. V. the question of the control of Unilever N. V. from London will become acute."[22] According to a scholarly work on Unilever, the firm changed its organization completely on September 1939, when the Second World War broke out.[23] Although the absolute loss of control of Unilever N. V. from London occurred in 1939, reorganization in 1937 also contributed to the loss of control of the continental business from London headquarters. Unilever's history illustrates how adopting a corporate structure to circumvent taxes can precipitate decentralized management years later.

3. (3) Short Summary of Case Studies

This paper examined five UK multinationals with overseas branches. Brunner Mond, Royal Dutch Shell and ICGA converted overseas branch offices into subsidiaries to

---

[19] Ibid., 231-232.
[20] Wilson, C., *The History of Unilever Vol. 1, 2* (London: Cassell, 1954).
[21] Wilson, C., *The History of Unilever Vol. 2* (London: Cassell, 1954), 309-316.
[22] Unilever, *Supporting Documents to Special Committee Minutes, No. 2402-2430*, Unilever Archives, UNI/BD/SC/2/42.
[23] Wubs, B., *International Business and National War Interests Unilever between Reich and Empire 1939-1945* (London/New York, Routledge, 2008), 77-80

circumvent UK income tax policies and inevitably had to appoint local boards of directors. Furthermore, British Ford, Royal Dutch Shell and ICGA stockpiled their overseas profits in overseas subsidiaries to prevent UK taxation. In the case of ICGA, these tax avoidance strategies brought about difficulties in communication and weakened the tight control of subsidiaries from its UK headquarters. Unilever chose to establish dual parent companies in the UK and the Netherlands in 1929, much as Royal Dutch Shell had done. The company reorganized the corporate structure for maintenance of the equalization agreement and allotted all continental European assets to the continental headquarters in 1937, fearing that the London headquarters would lose the ability to monitor its continental counterpart.[24]

4. Conclusion

Even in the interwar period, tax planning to soften tax burdens produced various types of tax strategies such as reorganization of business entities, use of tax havens, or establishment of financial subsidiaries to utilize thin capitalization for tax avoidance. And some of them involved changes in corporate management of the parent companies.

These case studies have implications for a better understanding of the relationship between multinationals and taxation. They highlight three key points. First, the problem of double business income taxation was caused by factors in home countries as well as in host-country. Previous studies of political risk management during the interwar period generally emphasize the influence of the latter (e.g. the Nazi regime). However, this study demonstrates that UK tax legislation encouraged British multinationals to circumvent the UK income tax system. For example, when we compare the double business income taxation relief system in the UK with those in the US, we can understand the difference of the trend of foreign direct investment between the UK and the US more thoroughly.

Second, this study endorses previous research concerning political risk management and demonstrates that taxation affected corporate behavior, particularly control by parent companies. A so-called European multinational model, multinational type, suggested by Bartlett and Ghoshal could have been formed in response to double business income taxation as well as national protectionism.

Third, avoidance of double business income taxation encouraged companies to create foreign subsidiaries and dismantle branch offices. Although the resulting operational difference may have been small, foreign subsidiaries could stockpile their profits, leading to their eventual independence.

[24] Nevertheless, tax avoidances by multinationals did not always cause weaker control of overseas business from parent companies. Rio Tinto set up a holding company in Switzerland in 1929. This subsidiary had no function other than tax avoidance because it obeyed the London Office (Rio Tinto, 'Memorandum on the subject of holding companies in Switzerland, 18 October 1928' in *Silica Gel Holding S.A., Formation and Statutes 1928-1929*, LMA, R. T. C. 20-D-6/4. Rio Tinto, 'European Organisation, 21 January 1929' in *Silica Gel Corporation, Silica Gel Limited, Davison Chemical Co., Agreements Shareholdings Reorgnisation 1928-1934*, LMA, R. T. C. 20-D-6/2).