Multinational Enterprises and International Double Taxation, 1914–1945: A Comparison between the UK and Japan

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Introduction

Business historians have rarely considered the subject of taxation (excluding tariffs[1]) to be important. Nevertheless, the main aim of business history is to study and explain the behavior of firm over long periods of time and to place the conclusions in a broader framework composed of the markets and institutions in which that behavior occurs (Wilson 1995, p.1). Management studies have addressed the factor of taxation as an external environment to be considered (DiMaggio and Powell 1983, p. 150; Porter 1990; Vernon 1998). However, few empirical studies have investigated the impact of taxation on corporate structure and strategy.

Within the field of taxation study itself, an increased focus on international taxation has been evident recently. For example, the sensational leak of the Panama Papers in 2016 prompted worldwide debate about international tax systems. The subject of history of multinational enterprises (MNEs) and international taxation deserves further academic study.

Although historical study on MNEs and international taxation has been limited, some studies on the subjects are worth mentioning. Mollan and Tennet (2015) studied international taxation and the corporate strategy employed by British overseas

[1] In a textbook on the history of international business, Geoffrey Jones regarded tariffs as a factor that encourages local production or withdrawal from foreign countries (Jones 2005).

businesses from 1900 to 1965, which is remarkable. In the article, they mainly extracted the data of British overseas business engaging in tax planning from British newspaper's sources, *The Times, The Financial Times,* and *The Economist*. The authors demonstrated that British firms responded dramatically to international taxation and changed corporate structures, locations, and/or domiciles in some cases. Izawa (2014, 2015a, 2015b, 2015c, 2015d) also studied the history of British MNEs and international taxation from 1914 to 1945. These papers drew upon primary and secondary data on British MNEs, such as Unilever, Rio Tinto, J&P Coats, and Imperial Continental Gas Association, to demonstrate how British MNEs' tax-minimization techniques affected corporate structures and strategies.

The limited historical study on MNEs and international taxation exclusively focused on the British experience. Although this focus is understandable given the magnitude of British overseas investment in the first half of the 20th century, the feature of the British experience cannot be outlined only by its own one. Comparative history could contrast different societies or cultures and highlight their respective individual features more (Skocpol and Somers 1980, p. 3). A comparison of the British and American experiences seems warranted given those nations' foreign domestic investment (FDI) before World War II; however, the UK's system of international taxation more resembled that of Japan, not the US. Accordingly, this study compares the British and Japanese experiences of establishment of international tax system before World War II and their MNEs' response to the tax environment.

This paper is structured as follows. Section 1 summarizes the author's early works of history on British MNEs and international taxation. Section 2 explores the history of Japanese MNEs and international taxation. Section 3 draws upon Bartlett and

Ghoshal (1989) to analyze the UK and Japanese experience and locate the British experience more precisely within business history.

1. British experience

1.1 Tax regime of the UK

British MNEs were imposed with international double taxation on business income since the First World War. Before 1914, the tax authority of the UK imposed a corporate income tax on overseas profits of British firms only when they remitted profits to the UK. Given that income tax rates in the UK and developed countries were extremely low (5.8% in the UK in 1913; federal income tax in the US was 1% at the same year), international double taxation was not considered to be a serious problem.[2] Following a tax rule change introduced by the Finance Act of 1914 and the fiscal burden of prosecuting World War I (see Figure 1), however, British MNEs began to regard double taxation of income as a serious problem even though the Finance Acts of 1916 and 1918 provided temporary foreign tax relief during the war (Jones 2013, Izawa 2015c, 2015d).

The UK's international taxation system until 1945 was shaped by the Finance Act of 1920. The 1920's Act provided foreign tax credit and limited it to a maximum half credit. However, the foreign tax credit was given only to the British Empire. Then it was not until the UK–US tax treaty in 1945 that the UK government provided foreign tax credit toward MNEs operated outside the British Empire (Picciotto 1992, pp. 38-41). On the other hand, the 1920's Act untouched the rule that granted a deduction of foreign

[2] In 1860, the House of Commons discussed international double taxation of income between the UK and India. The Imperial Conference in 1911 also discussed the problem. However, no solution was provided before the Financial Act of 1916. See Izawa (2015d).

tax from the tax base. Then, the UK's international taxation system provided foreign tax deduction outside the Empire (Jones 2013).[3]

In addition, UK's tax legislation involved an "effective management" rule. UK MNEs could not escape their potential income tax liability based on their profits unless all their activities, management, and control occurred abroad (Picciotto 1992, pp. 7-9).

1.2 British MNEs operating in the British Empire and international taxation

The foreign tax credit provided by the Finance Act of 1920 pacified complaints about international double taxation among British MNEs operating in the British Empire, although it did not completely prevent double taxation even within the Empire. Figure 2 (a) shows that the number of complaints printed in *The Times*, *The Financial Times*, and *The Economist* declined after the Finance Acts of 1916 and 1920 (19 in 1916, 5 in 1918, and none in 1922). Tax complaints rarely appeared in the press until World War II (Figure 3).

However, the lower number of complaints does not suggest British MNEs ceased attempting to minimize international double taxation. British firms operating overseas such as Joseph Nathan and Co. (later GlaxoSmithKline) reorganized corporate structures to alleviate tax burdens (Mollan and Tennet 2015, pp. 1061–1062). Other companies abandoned their overseas businesses for tax reasons. For example, Johannesburg Consolidated Investment Co. ceased investing in hotels in South Africa and sold its business (*The Times*, Dec. 29, 1921). Figure 2 (b) shows that one-fifth of the

[3] For example, let income of a resident in Nation A earned in Nation B be 100, A's tax rate be 20%, and B's tax rate be 10%. Under the foreign tax credit, income after tax $= 100 - (100 \times 0.1) - \{100 \times (0.2 - 0.1)\} = 80$. Under the foreign tax deduction, income after tax $= 100 - (100 \times 0.1) - \{(100 - 100 \times 0.1) \times 0.2\} = 72$.

companies that complained in the press about international double taxation relocated their headquarters or sold their business. As might be expected, companies operating within the Empire undertook fewer tax-inspired maneuvers than those operating outside it. Although 17% of the former carried out plans for tax reasons, 36% of the latter relocated headquarters or sold their overseas businesses.

World War II exacerbated the problem of international double taxation, even among firms operating within the British Empire. Complaints by British companies revived (one in 1938, two in 1940, and six in 1944 appeared in *The Times*). Moreover, the Treasury prohibited UK-domiciled companies from transferring businesses abroad without its consent on Sep. 27, 1940; for example, it stopped the Great Boulder Proprietary Gold Mines from transferring control and administration from the UK to Australia (*The Times*, Aug. 29, 1940, p. 8; *The Times*, Sep. 28, 1940, p. 7).

1.3 British MNEs operating outside the British Empire and international taxation

In general, British MNEs, especially those operating outside the Empire, both complained about international double taxation and acted to alleviate their tax burdens through tax planning.[4] This subsection analyzes two big British MNEs, the primary documents of which were held at some archives, to discern the impact of tax planning on corporate structure and strategy. Tax planning affected both companies' corporate structures and management style, albeit at differing speeds.

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[4] For a more detailed analysis covering companies such as Rio Tinto, J&P Coats, ICI, and Royal Dutch Shell, see Izawa (2014 and 2015a, b).

(1) **Imperial Continental Gas Association—Tax planning directly affected management**

In 1930, Imperial Continental Gas Association (ICGA)—a major provider of gas and electricity to continental Europe—had a market capitalization of £9.24 million, comparable to that of Tate & Lyle, the UK's 36th-largest company (Bourne-Paterson 1970; Chandler 1994, Appendix B.2). ICGA had the character of a so-called free-standing company in that its UK revenues were only 15% of total revenues in 1930. In a statement from a company meeting in 1931, ICGA called itself "one of the most unfortunate victims of double taxation" because "Belgian taxation authorities deduct 22% from the gross amounts of our dividends and British authorities 22.5% from the remainder."[5]

The company took two measures to alleviate double taxation. First, in 1927, it created "[t]he 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, it decided "not to press the subsidiary companies for dividends in excess of the sum required to yield a reasonable rate of dividend." Furthermore, ICGA stated, "reserves will be created in the subsidiary companies."[6] In short, ICGA created a financial subsidiary to take advantage of international differences in taxation of dividends and interest. Belgian law defined companies without offices or permanent establishments in Belgium as foreign companies and taxed interest paid to foreign companies at the reduced rate of

5 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, London Metropolitan Archives.
6 Ibid.

5%. Therefore, ICGA established a private company—the Utility Loan Company—to lend money to its Belgian subsidiaries (Bourne-Paterson 1970, Appendix 3a.1.).

ICGA's second action was to convert branch offices in Belgium into Belgian subsidiaries. Double taxation on business income arose when overseas subsidiaries remitted dividends, but no tax was applied when subsidiaries retained their profits. However, UK authorities taxed profits of overseas branches, whether remitted or not. Therefore, by converting its branches into subsidiaries, ICGA could retain profits in Belgium. It did so in 1929, and revenue from Belgian branches—the majority of its dividends—plummeted in 1930.

Arguably, however, a reshuffling of personnel was the greatest consequence of ICGA's 1930 reorganization. In December 1930, ICGA created the new Belgian position of "Liaison Officer for ICGA and its Associated Companies". The appointee, Maurice Perier, executed a long-considered plan to localize ICGA's Belgian operations, and Belgian subsidiaries ceased receiving directors dispatched by ICGA's London headquarters (Bourne-Paterson 1970, pp. 231–232).

Ultimately, ICGA's corporate structure resembled that of a pure holding company, but by reorganizing to exploit Belgian tax policy, ICGA forfeited control of its Belgian business. ICGA's history demonstrates how revising corporate structure to circumvent double taxation can lead to decentralized management.

(2) Unilever—Tax planning affected management

A remarkable organizational aspect of Unilever is the dual structure it adopted after its formation in 1929, following the cases of Van den Berg, a constituent of Unilever. To secure favorable tax treatment, Unilever concluded an equalization agreement and maintained two headquarters: Unilever Limited in the UK and Unilever N.V. in the Netherlands (Wilson 1954a, pp. x vii; Wilson 1954b, pp. 231–238).

Besides, in December 1937, Unilever had to reorganize its business structure to implement the equalization agreement. The emergence of a Nazi administration had reduced profits at Unilever N.V.: profits from Unilever N.V., which were two-thirds of Unilever's overall profit in 1930, were one–third in 1937. When Unilever N.V. allocated the reduced profit to Unilever Limited, it incurred double taxation. To alleviate the problem, Unilever assigned its entire European and US businesses to Unilever N.V. and confined operations of Unilever Limited within the British Empire (Wilson 1954b, pp. 309–316).

Before the 1937 reorganization, Unilever's board expressed concern about loss of control from London in a special committee memorandum in November 1937: "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."[7] Unilever completely reorganized in September 1939 when World War II erupted (Wubs 2008, pp. 77–80). Although London lost absolute control over Unilever N.V. in 1939, that loss started when the 1937 reorganization removed all continental operations from its purview. Unilever's history illustrates how adopting a corporate structure to circumvent taxes can precipitate decentralized management years later.

[7] Unilever, *Supporting Documents to Special Committee Minutes, No. 2402–2430,* Unilever Archives, UNI/BD/SC/2/42.

2. Japanese experience

2.1 Tax regime of Japan

The year 1920 also marked the turning point of the prewar system of international taxation in Japan, with the Japanese government revising its Income Tax Act (*Syotoku-Zei*) and abandoning the extraterritorial income exclusion system. Instead, it made all foreign-sourced income taxable to Japan-domiciled firms. The foreign tax deduction system was introduced as a form of tax relief (Hara 2007).

However, Japanese businesses operating within the Japanese Empire did not confront with international double taxation. Unlike the British Empire, where the suzerain relatively granted client states or territories latitude with regard to taxation, client states or territories of the Japanese Empire had no such rights. Therefore, jurisdictions within the Japanese Empire could not alter their tax systems without the consent of Japan. For example, the Korean authority enacted its Income Tax Decree on the day the Japanese government legislated its Income Tax Act of 1920. The tax rate and rules specified in Korea's decree were identical to the Japanese Act (5-20% in Japan and Korea in 1920). As a result, business income was taxed uniformly within the Japanese Empire. A company operating in a jurisdiction within the Japanese Empire paid tax to that jurisdiction, and other jurisdictions within the Empire imposed no tax even if the company expanded beyond the registered country/area. Thus, Japan prevented international double taxation within its Empire (Okura-Syo 1957).

Accordingly, international taxation of business income in Japan from 1920 to 1945 was nearly fully tax-coordinated within the Japanese Empire, and the foreign tax deduction system was applied to outside it. Unlike the US, which introduced unlimited credits for foreign taxes paid in 1918,[8] Japan and the UK distinguished between inner- and outer-Empire regions (Graetz and O'Hear 1997). Although the strength of coordination differed within the two Empires, the character of international taxation system was, to some extent, similar.

2.2 Japanese MNEs operating in the Japanese Empire and international taxation

The Japanese overseas business that operated within the Empire was not concerned about international double taxation basically. However, when companies could seize opportunities to catch the international taxation system of the Japanese Empire unguarded, they manipulated its system to save the tax burden.

For example, Nihon Chisso (Japan Nitrogenous Fertilizer Company) Group, one of the new *Zaibatsu*, established a wholly owned subsidiary (Chosen Chisso) in Korea in 1927. Despite the fact that the reality of the subsidiary was one of the branch plants, the Chosen Chisso (Korea Nitrogenous Fertilizer Company) was set up as a separate legal entity from the parent to use special tax reduction for the promotion of investment in Korea. After Nihon Chisso Group exploited the four-year special tax provision, the Korean subsidiary ceased paying dividends to Nihon Chisso and instead paid it huge patent royalties and sales commissions. Chosen Chisso could treat these royalties and commissions as deductible expenses and reduce taxable profits. Eventually, the Ministry of Treasury of Japan considered the manipulation to be a serious problem. In 1941, the Korean company was forced to be merged into the parent company (Oshio 1989).

[8] The Revenue Act of 1921 introduced a limitation on this foreign tax credit to ensure that a taxpayer's total foreign tax credit could not exceed the amount of US tax liability on the taxpayer's income from foreign sources. (Gratez and O'Hear 1997).

The relationship between Japan and Manchukuo (Mansyu-Koku), fabricated by the Japanese Empire in 1932, was peculiar. Initially, international double taxation occurred because Japan created Manchukuo as an independent puppet state. Many Japanese businesses operating there, such as Ajinomoto, incurred international double taxation (Ajinomoto 1951, p.503). Finally, a royal decree to prevent international double taxation between Japan and Manchukuo was issued in 1942.[9]

However, some companies enjoyed tax privileges before the decree. As one remarkable example, Nissan (Nihon Sangyo) Group, one of the new *Zaibatsu*, relocated its headquarters to Manchukuo mainly to secure a tax privilege. In 1936, Nissan vehemently complained about the tax burden in Japan. Amid rumors Nissan would be dissolved, its president decided to move its headquarters to Manchukuo in 1937. Nissan and the Japanese and Manchukuo governments consented to a plan in which Manchukuo not only imposed 6% of its income tax on Nissan's business there but waived the tax right on the Nissan's business in Japan. Given that Japan's income tax rate in 1937 was 10%, the agreement was favorable for Nissan. Nissan changed its name to Manchurian Heavy Industrial Development Corporation, which was dissolved in 1945, and succeeded to the Nissan Motors and Hitachi (Hara 1976).

2.3 Japanese MNEs operating outside the Japanese Empire and international taxation

The amount of Japan's outward FDI was not large at the absolute level but was moderate at the relative level. Outward FDI stock as a percentage of home country GDP

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[9] For more detailed information, see Shibata (2007). Company law of Manchukuo in 1937 exacerbated double taxation between Japan and Manchukuo. It prompted Japanese branches into Manchukuo's subsidiaries.

in 1914 was 7.8% in Japan, 53.2% in the UK, 6.8% in the US, 18.3% in France, and 10.7% in Germany (Held 1999, p.275). Kuwahara (1990) estimates Japan's outward FDI stock in 1930 was 11.5–13.6%, with investment in Korea and Taiwan excluded in the estimation. Accordingly, some Japanese firms operating outside the Empire confronted with double taxation on international income.

However, Japanese MNEs operating outside the Japanese Empire apparently did not regard double taxation as a serious problem, generally. First, outward FDI of pre-war Japan mainly involved mainland China, and Japanese companies could use the extraterritorial rights of foreigners. For example, Japanese owned cotton firms in China (Zaikabo), mainly were located in Shanghai and Qingdao. According to Okabe (1937), overall tax burden on business income in Japan was 17-20%. In contrast, the tax rate in Shanghai was estimated to be 3.4-6% and the Qingdao's rate was 1.7-2%. Japanese MNEs in mainland China appears not to have serious problem of international double taxation on business income (Okabe 1937).

More important was that Japanese MNEs operating outside the Empire seemingly feared losing control of their overseas businesses. For example, in Australia, all Japanese MNEs except Kanematsu, a wool-trading company, remained legal entities of its Australian operation as branches (Amano 2010; Fujimura 2011).[10] Similarly, most Japanese MNEs operating in the US were reluctant to convert branches into subsidiaries.

[10] Ten of 13 Japanese MNEs operating in Australia chose branches. Kanematsu permitted formation of an Australia subsidiary, F. Kanematsu (Australia) Ltd, to prevent international double taxation in 1922. A board member of the subsidiary was Australian. Although Arai Syoten set up the Australian company, the main base of business appears to have been Australia, not Japan. The president was granted permanent residence and probably lived in Australia. Perhaps Arai Syoten was regarded as a freestanding company, but information about it and another company, Kiku Gumi, is lacking.

The example of Mitsui Bussan, the biggest general trading company (*Sogo Shosha*), revealed the mentality of Japanese MNEs. After World War I erupted, gross profits of Mitsui's US branch burgeoned and attracted the attention of US tax authorities. Although the branch escaped additional tax, its manager sent a report to the headquarters: "The problem might possibly occur again. A fundamental solution is to convert the US branch offices into US subsidiaries."[11] However, the headquarters did not change the corporate entity. Perhaps the following president's policy affected the (non-)decision: "I have patronized Japanese workers since 1879, and we persist in the policy until today. If foreign workers follow the Mitsui way, it is OK. However, if we recruit some foreign workers following the foreign way, our policy will be broken" (Mitsui Bussan 1906, p. 236).[12]

3. Summary and Discussion

As shown in Section 1, international double taxation compelled the British government to change the UK's system of international taxation in 1920. The revised system provided a credit for taxes paid to countries within the British Empire and a deduction for taxes paid in countries outside the Empire. That arrangement persisted until 1945. Forced by the business environment, British MNEs sold overseas businesses or changed corporate structures, locations, and domiciles to avoid double taxation on business income. Some MNEs such as ICGA and Unilever decentralized both corporate structures and management styles, albeit at differing speeds. On the other hand, tax

[11] Mitsui Bussan, *Beikoku Syotokuzei Gaiyo*, *1917–1918*, (1928), p. 167, National Archives and Records Administration, RG 131, A1 72, Box 7.

[12] Mitsui converted branches in Germany, France, and other three countries into subsidiaries in order to avoid international double taxation. Yet, all board members were Japanese. Moreover, it continued to treat subsidiaries as branch offices.

relief within the British Empire presumably assured that companies operating within the Empire engaged in fewer tax maneuvers than those operating outside it, at least until World War II.

Section 2 described how the international taxation system of Japan was shaped and affected management of Japanese MNEs. The Japanese government also differentiated between inner- and outer-Empire regions. Although Japanese MNEs operating within the Japanese Empire theoretically did not need to engage in tax-reducing maneuvers, tax incentives in Korea or the establishment of Manchukuo presented special situations. It appears that most Japanese MNEs operating outside the Empire and mainland China were reluctant to carry out tax minimization. Overall, it seems that Japanese MNEs operating outside Japan's area of influence shunned decentralizing corporate structures to minimize taxes but intended to retain control over overseas business. Differences in foreign tax relief within Empires also seemingly reflect the prewar mentality of the Japanese and British.

These observations can be connected with the theory of international business advocated by Bartlett and Ghoshal (1989), who characterized European MNEs as decentralized structures of nationally self-sufficient units (multinational type) and Japanese MNEs as centralized structures that retained control over decisions, resources, and information (global type). While Bartlett and Ghoshal (1989) recognized national protectionism as one of the main reasons why the European MNEs became multinational in nature, the problem of international double taxation from 1914 to 1945 would also encourage the British MNEs to become multinational type. On the other hand, given the experience of Japan, international double taxation would not always encourage to decentralize MNEs' corporate structure and management style. We might have to revisit and explore the so-called mentalités, culture, or social structure (Bloch 1924; Parsons 1951; Bucheli and Wadhwani 2013).

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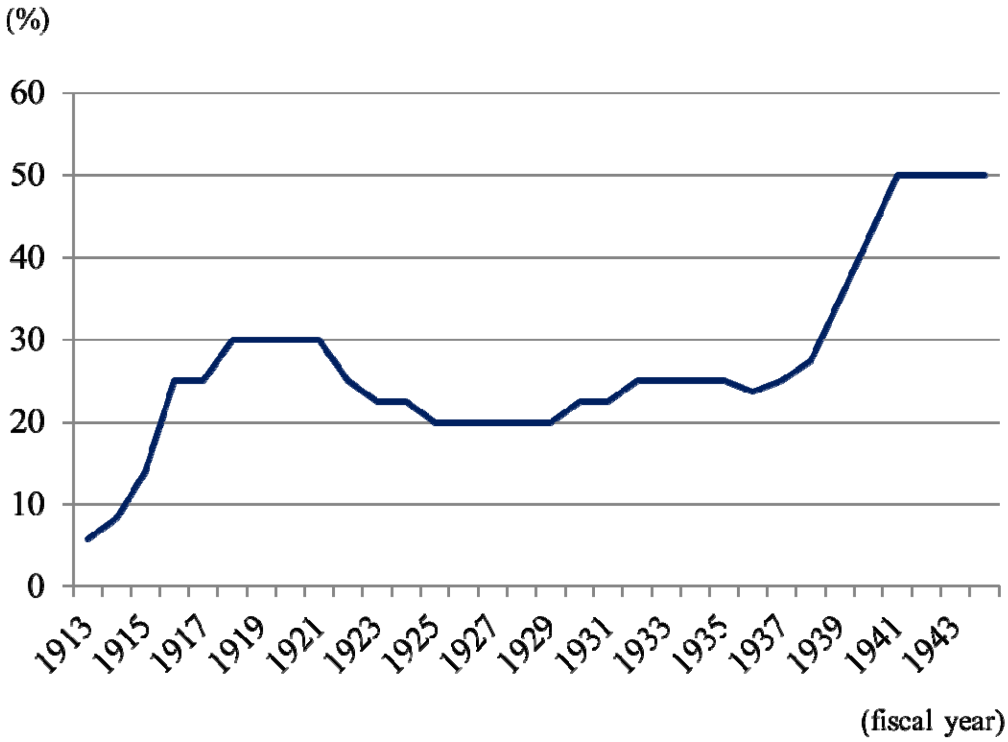
Figure 1. The rate of income tax on business income of the UK, 1913-1944



Source: Daunton, M. *Just Taxes: The Politics of Taxation in Britain 1914-1979*, p.14

Figure 2(a). The number of companies, complaining about "double income tax" and "double taxation" on the columns of company meeting of *The Times*, *The Fiancial Times, The Ecoomist*

Fiscal Year	Total	Empire	Foreign	Australia	South Africa	New Zealand	India	Canada	Bolivia	France	Dutch Indies	US	Netherland	Mexico	others
1914	2	2	0	1	1										
1915	3	3	0		1		2								
1916	23	19	4	12	2	5	2		1	1		2			
1917	12	12	0	8	2	2		1							
1918	5	5	0	4		2									
1919	6	5	1	4	1	1					1				
1920	5	3	2	2				1			1	1			
1921	8	4	4	1	1	1	1	1		1	2			1	
1922	1	0	1							1					
1923	5	1	4		1					1		1	1		1
	70	54	16												

Source: Izawa(2015d)
Note: Overlap was excluded when a company complained its tax burden on the different newspapers in the same year.

Figure 2(b)The number of the companies listed table 2 classified countries, industries

	Total	Relccated	Sold
Australia	14	1(1920)	
South Africa	7	1(1923)	1(1921)
New Zealand	6	1(1916)	
India	4	2(1915, 1921)	
Australia and India	2		
Australia and NZ	1		
Canada	2		
Empire	36	5	1
Dutch Indies	4		1(1920)
US	4		1(1920)
France	2	1(1916)	
Bolivia	1	1(1916)	
Mexico	1		
Netherland	1		
Others	1		
Foreign	14	2	2
計	50	7	3

Industry	Total	Relocated	sold
Brewery	2		
Electoric	1	1	
Immovable Property	1		
Finance(Bank, Insurance)	15		2
Mining	10	2	1
Livestock Breeding	5	1	
Railway, Tramway	5	2	
Railway and Mining	1		
Oil, Rubber	4		
Textile	1		
Trading Company	3	1	
Unknown	2		
	50	7	3

Source: Izawa(2015d)

Note: Overlap was excluded when a company complained its tax burden on the different newspapers.

Figure 3. The number of companies, complaining about "double income tax" and "double taxation" on the columns of company meeting of *The Time*

	Ceylon	Australia	South Africa	Canada	Trinidad and Tobago	Rhodesia	Egypt	Other areas within Empire	Canada and US	US	Dutch Indonesia	France	Netherland	Belgium and France	Colombia	Brazil	Others
1924										1							
1925										1							
1926										1							
1927												1					
1928																	
1929										1							
1930												1					1
1931												1					
1932														1			
1933																	
1934																	
1935																	
1936																	
1937										1			1				
1938	1									1	1						
1939								2		1	1						
1940		1				1					5						
1941				2							2				1		1
1942	2	2		1						2							1
1943				1	1					1	1						1
1944		3	1				1	2	1	2						1	5

Source: Izawa(2015c)