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Evolution of Territorial Tax Systems in the OECD

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Executive Summary

Countries generally use one of two methods to reduce or eliminate double international taxation of income earned abroad by multinational companies -- the "worldwide" and the "territorial" method. Under the worldwide method, income earned abroad by foreign subsidiaries is subject to tax by the home country with a credit for income taxes paid to foreign governments. Under the territorial method, also referred to as a "participation exemption" system, active business income earned abroad by foreign subsidiaries is wholly or partially exempt from home country tax with no credit for foreign taxes.

This report, prepared for the Technology CEO Council, documents the pronounced shift over the past 40 years toward use of territorial tax systems among the advanced economies that are members of the Organization for Economic Cooperation and Development (OECD).

In brief, the report finds that:

- As of 2012, 28 of the 34 current OECD member countries (82 percent) have adopted territorial tax systems that exempt 95-100 percent of qualifying dividends received from foreign affiliates resident in some or all countries. Twenty countries exempt 100 percent and eight exempt between 95 and 100 percent of qualifying foreign dividends.

- The number of current OECD member countries with territorial tax systems has doubled since 2000.

- OECD member countries commonly require 10-percent ownership of a foreign affiliate's shares for a one-year period as one condition to qualify for the territorial exemption.

- Most OECD member countries with territorial tax systems exempt active income earned by foreign affiliates as well as gain on the sale of foreign affiliate shares.

- Some OECD member countries with territorial tax systems limit the exemption to affiliates resident in countries with which they have a treaty relationship or that have robust income tax systems.

- Two OECD member countries (Finland and New Zealand) have switched from a territorial to a worldwide tax system and both have reinstated territorial taxation. The six OECD countries that currently have a worldwide tax system have used that system at least since the Second World War.

- Competition from multinational companies headquartered in territorial countries is growing. The share of sales of OECD-based companies on the Forbes 500 list headquartered in countries with territorial tax systems has increased from 11 percent

in 1985 to 59 percent in 2012. By 2012, 91 percent of the non-US OECD-headquartered companies on the Forbes 500 list were headquartered in countries with a territorial tax system. Similarly, 93 percent of the sales of non-US OECD-headquartered companies on the Forbes 500 list were from companies headquartered in countries with a territorial tax system.

- The growing significance of multinational companies based in territorial jurisdictions also can be seen from the share of outbound foreign direct investment (FDI) from OECD countries that comes from countries with territorial tax systems. The total stock of outbound FDI from OECD countries with territorial tax systems has increased from 22.4 percent in 1980 to 69.9 percent in 2011.

Evolution of Territorial Tax Systems in the OECD

I. Introduction

Countries generally use one of two methods to reduce or eliminate double international taxation of income earned abroad by multinational companies -- the "worldwide" and the "territorial" method.

Under the worldwide method, income earned abroad by foreign subsidiaries is subject to tax by the home country with a credit for income taxes paid to foreign governments. Most countries limit the credit for foreign income taxes to home country tax on foreign income, determined using a per-item, per-country, or overall approach. The United States adopted a foreign tax credit system in 1918 and enacted a foreign tax credit limitation in 1921.

Under the territorial method, also referred to as a "participation exemption" system, active business income earned abroad by foreign subsidiaries is wholly or partially exempt from home country tax with no credit for foreign taxes. Under a territorial system, qualifying foreign subsidiary earnings can be repatriated with little or no tax; whereas, under a worldwide system, repatriated income generally is subject to additional tax if the foreign rate of tax is below the home country rate.

Non-equity income, such as interest, rents, and royalties, generally is taxable in countries with both worldwide and territorial tax systems and a credit for foreign withholding taxes generally is allowed.

Many countries have Controlled Foreign Corporation (CFC) regimes that treat certain passive or mobile income of foreign subsidiaries as if earned directly by domestic shareholders and that allow a credit for related foreign income taxes.

Because foreign subsidiary earnings are subject to additional home country tax when repatriated to countries with worldwide tax systems, companies have an incentive to reinvest foreign earnings abroad. This is referred to as the "lockout" effect. As the United States has the highest corporate tax rate among the 34 members of the Organization for Economic Cooperation and Development (OECD), much of the foreign earnings of US multinational companies is trapped abroad as a result of the lockout effect.

To eliminate the lockout effect, adoption of a territorial tax system has been recommended by the President's Advisory Panel on Federal Tax Reform (2005), the co-chairs of the National Commission on Fiscal Responsibility and Reform ("Bowles-Simpson" Commission, 2010), the President's Export Council (2010), the President's Council of Advisors on Science and Technology (2011), and most of the members of President's Council on Jobs and Competitiveness (2011).

This report, prepared at the request of the Technology CEO Council, reviews the territorial tax systems used by 28 the 34 OECD member countries. Section II summarizes the territorial tax systems in effect in 2012; Section III discusses the evolution of these international tax systems over time; and Section IV quantifies the growing economic significance of territorial countries over the last 40 years.

II. Territorial Tax Systems in the OECD in 2012

As of 2012, 28 of the 34 current OECD member countries had adopted territorial tax systems (also referred to as participation exemption systems) that exempt most active earnings repatriated from subsidiaries resident in some or all other countries (see **Table 1**). In contrast, six OECD countries, the United States, Chile, Ireland, Israel, Korea, and Mexico, do not have some type of foreign dividend exemption system.

Table 1.– Method of Relieving Double Taxation of Foreign Subsidiary Income: OECD Member Countries, 2012

Territorial (participation exemption) System		Worldwide with Foreign Tax Credit
Australia*	Japan	Chile
Austria	Luxembourg	Ireland
Belgium	Netherlands	Israel
Canada*	New Zealand	Korea, Republic of
Czech Republic*	Norway	Mexico
Denmark	Poland**	United States
Estonia	Portugal*	
Finland	Slovakia	
France	Slovenia	
Germany	Spain	
Greece**	Sweden	
Hungary	Switzerland	
Iceland	Turkey	
Italy	United Kingdom	

*Exemption by treaty arrangement

**Exemption only for EU subsidiaries.

Twenty of the 28 OECD countries with territorial tax systems exempt 100 percent of eligible foreign subsidiary dividends, while eight exempt 95 percent or more (see **Table 2**). OECD countries with territorial tax systems rarely allocate and apportion domestic expenses, such as interest expense, against exempt foreign income. Countries that exempt less than 100 percent of foreign subsidiary dividends (typically 95 percent) often justify partial exemption as an administratively simple proxy that serves in lieu of expense allocation.

Many of the OECD countries with territorial tax systems extend the exemption system to active income from foreign operations conducted directly by domestic companies through foreign branches. In these cases, active foreign income earned by the branch is fully exempt from home country taxation.

Three-fourths of the OECD countries with territorial tax systems also exempt gains realized on the sale of foreign subsidiary shares.

Many countries have Controlled Foreign Corporation (CFC) regimes that treat certain passive or mobile income of foreign subsidiaries as if earned directly by domestic shareholders and allow a credit for related foreign income taxes.

Some OECD countries limit territorial exemption to dividends received from specified countries. Two OECD members limit their territorial tax system to investments in European Union (EU) countries, three countries tie territorial taxation to income tax treaties and/or EU membership, 12 countries use some form of "white list" (specifying eligible countries) or "black list" (specifying ineligible countries), and 11 countries have no geographic limitation. Where the exemption system is not available, OECD countries with territorial tax systems generally tax foreign subsidiary dividends upon repatriation with a credit for foreign income taxes.

Seven OECD countries with territorial tax systems have no minimum foreign affiliate ownership threshold required to qualify for the territorial exemption. The other countries generally require ownership of 10 percent (or less in some cases). Japan requires a 25-percent ownership threshold.

Half of the OECD countries with territorial tax systems have no minimum foreign affiliate holding period requirement to qualify for the territorial exemption. The other countries generally require the parent company to own foreign affiliate shares for 12 months (6 months in Japan), except that a 24-month holding period is required in France, Greece, Norway (for foreign affiliates outside the EU), Poland, and Portugal (for foreign affiliates outside the EU).

In summary, over 80 percent of OECD member countries employ some type of territorial tax system that exempts qualifying dividends received from foreign affiliates. Some of these countries limit territorial exemption to affiliates resident in countries with which they have a treaty relationship or that have robust income tax systems. Most of these countries also exempt gain on the sale of foreign affiliate shares.

Table 2.– Territorial Tax Systems in OECD Member Countries, 2012

Country	Top combined corporate tax rate (2012)	Year that territorial was first in effect	Exemption percentage	Countries of foreign affiliates eligible for participation exemption	Minimum ownership percentage	Minimum holding period	Does exemption apply to active income of foreign branch?	Does exemption apply to gain on sale of shares?
Australia	30.0%	1991	100%	All countries	10%	none	Yes	Yes
Austria	25.0%	1972	100%	All countries	0% in EU, otherwise 10%	none in EU, otherwise 1 year	Yes	Yes
Belgium	34.0%	1962	95%	All countries with tax similar to Belgian corporate income tax	10% or 2.5 million Euro	1 year	Yes	Yes
Canada	26.1%	1951	100%	Treaty countries and countries with which Canada has signed a tax information exchange agreement	10%	none	No	No
Czech Republic	19.0%	2004	100%	EU member countries, treaty countries, and countries with a corporate income tax of at least 12%	10%	1 year	No	Yes
Denmark	25.0%	1992	100%	All countries	10%	none	Yes	Yes
Estonia	21.0%	2005	100%	All countries with a corporate tax of at least 7%	10%	none	Yes	No
Finland[1]	24.5%	1920	100%	EU member countries and treaty countries	10%	none	No	Yes
France	34.4%	1979	95%	All non-"black list" countries	5%	2 years	Yes	Yes
Germany	30.2%	2001	95%	All countries	none	none	No	Yes
Greece	20.0%	2011	100%	EU member countries only	10%	2 years	No	No
Hungary	19.0%	1992	100%	All countries	none	none	No[3]	Yes
Iceland	20.0%	1998	100%	Countries with corporate tax rate at least as high as the general rate in any member state of the OECD, EFTA, or the EU	unknown	unknown	No	Yes
Italy	27.5%	1990	95%	All non-"black list" countries	none	none	No	Yes
Japan	38.0%	2009	95%	All countries	25%	6 months	No	No

Table 2.– Territorial Tax Systems in OECD Member Countries, 2012 (Continued)

Country	Top combined corporate tax rate (2012)	Year that territorial was first in effect	Exemption percentage	Countries of foreign affiliates eligible for participation exemption	Minimum ownership percentage	Minimum holding period	Does exemption apply to active income of foreign branch?	Does exemption apply to gain on sale of shares?
Luxembourg	28.8%	1968	100%	All countries with an effective corporate tax rate of at least 10.5%	10% or 1.2 million Euro	1 year	No	Yes
Netherlands	25.0%	1914	100%	All countries	5%	none	Yes	Yes
New Zealand[2]	28.0%	1891	100%	All countries	none	none	No	Yes
Norway	28.0%	2004	97%	All non-"black list" countries	0% in EU, otherwise 10%	none in EU, otherwise 2 years	No	Yes
Poland	19.0%	2004	100%	EU member countries and Switzerland	10% for EU, 25% for Switzerland	2 years	No	No
Portugal	31.5%	1989	100%	EU/EEA member countries as well as Portuguese speaking African countries and East Timor (PSC)	10% for EU, 25% for PSC	1 year for EU, 2 years for PSC	No	No
Slovakia	19.0%	2004	100%	All countries	none	none	No	No
Slovenia	18.0%	2004	95%	EU member countries and all non-"black list" countries	none	none	No	Yes
Spain	30.0%	2000	100%	All countries with corporate income taxes similar to Spain other than tax havens	5% or 6 million Euro	1 year	Yes	Yes
Sweden	26.3%	2003	100%	EU member countries and countries with entities comparable to a Swedish limited liability company	10%	1 year	No	Yes
Switzerland	21.2%	1940	95%	All countries	10% or CHF 1 million	none	Yes	Yes
Turkey	20.0%	2006	100%	All countries with an effective corporate tax rate of at least 15%	10%	1 year	Yes	Yes
United Kingdom	24.0%	2009	100%	All countries	none	none	Yes	Yes

Source: PwC and the OECD Tax Database   Note: Table refers to general treatment. Exceptions may apply.

[1] Finland's territorial regime was not in effect between 1990 and 2004.

[2] New Zealand's territorial regime was not in effect between 1988 and 2008.

[3] While domestic law does not provide an exemption for foreign branch income, most tax treaties provide for full exemption.

Note: Israel adopted a limited participation exemption system in 2006. However, due to the restrictive nature of eligibility requirements, election of the exemption is not common.

III. Evolution of Territorial Tax Systems in the OECD

Territorial taxation dates back to the 19th century in the case of New Zealand (Land and Income Tax Assessment Act of 1891), to the 20th century for 12 other OECD countries, and to the first 12 years of the 21st century for the remaining 15 of the 28 OECD countries with territorial tax systems (see **Figure 1**).

One impetus for the recent acceleration in the rate at which countries have switched from worldwide to territorial tax systems is the expansion of European Union (EU) membership, from 15 to 27 countries since 2004. Although, the EU parent-subsidiary directive allows member states to elect either the worldwide or territorial methods for relieving double taxation of active business income earned by EU subsidiaries, 20 of the 21 EU countries that are OECD members use the territorial method (Ireland is the exception).

Many of the OECD countries that currently have territorial tax systems previously taxed foreign income exclusively on a worldwide basis. In contrast, only two countries switched from territorial tax systems to worldwide tax systems, and in both cases they reinstated territorial tax systems. New Zealand introduced rules that effectively repealed its territorial tax system in 1988, but switched back to a territorial tax system in 2009. Similarly, Finland repealed its territorial regime in 1990 and switched back to a territorial system in 2005. The six OECD countries that currently have a worldwide tax system have used that system at least since the Second World War.

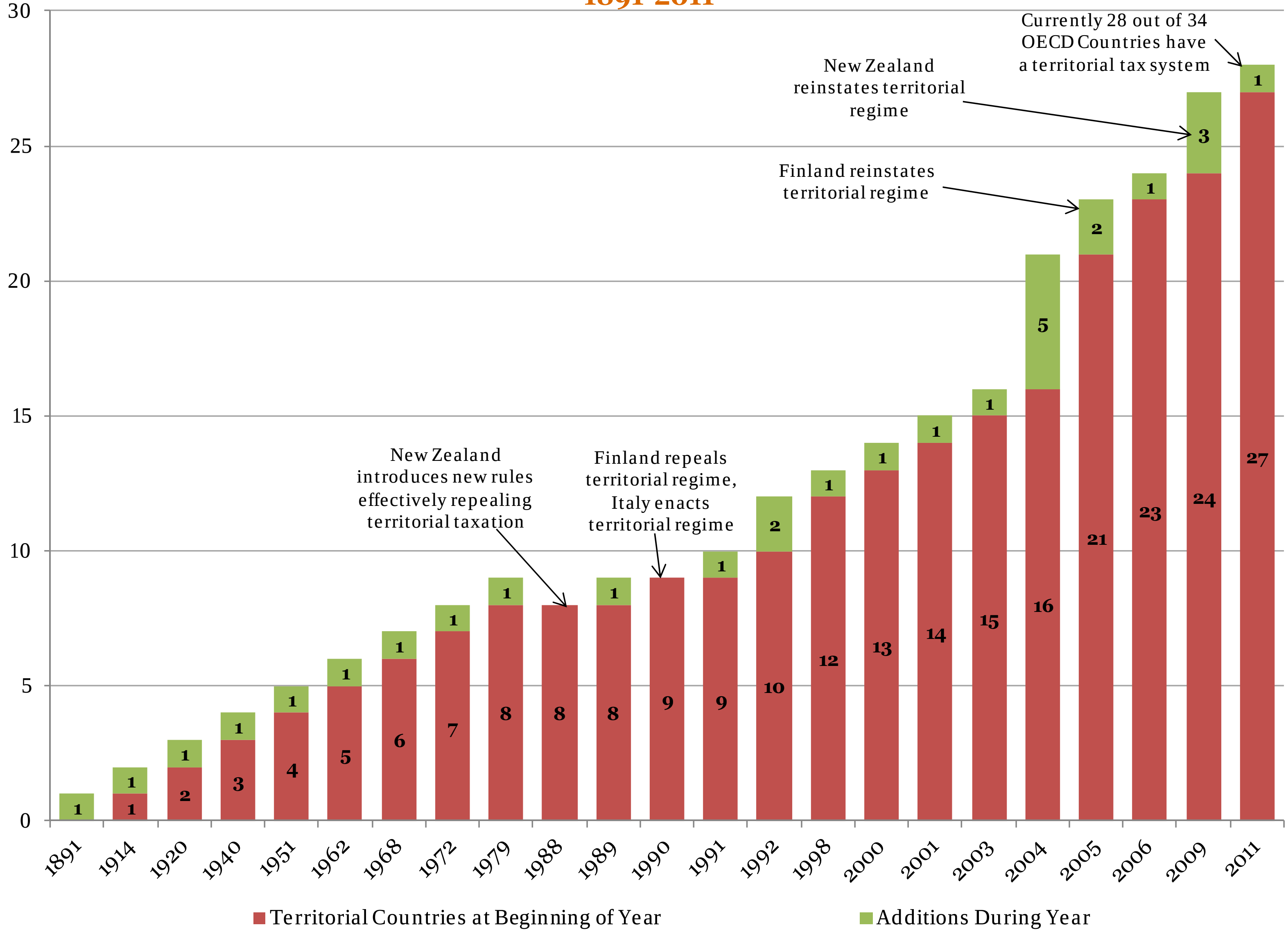
OECD countries have amended the scope of their territorial tax systems over time, both broadening and narrowing eligibility for dividend exemption.

Examples of countries that have broadened the scope of their territorial tax system are listed in Table 3. Australia, Czech Republic, Norway, and Portugal have increased the geographic scope of their exemption systems. For example, when Australia enacted its territorial tax system in 1991, the exemption was only available to dividends from countries with comparable tax systems (Canada, France, Japan, New Zealand, the UK, and the US). However, beginning in 2004, Australia's exemption system applies to subsidiaries in all countries.

Other countries have increased the scope of their participation exemption system by reducing share ownership percentage and holding period requirements or by increasing the exemption percentage.

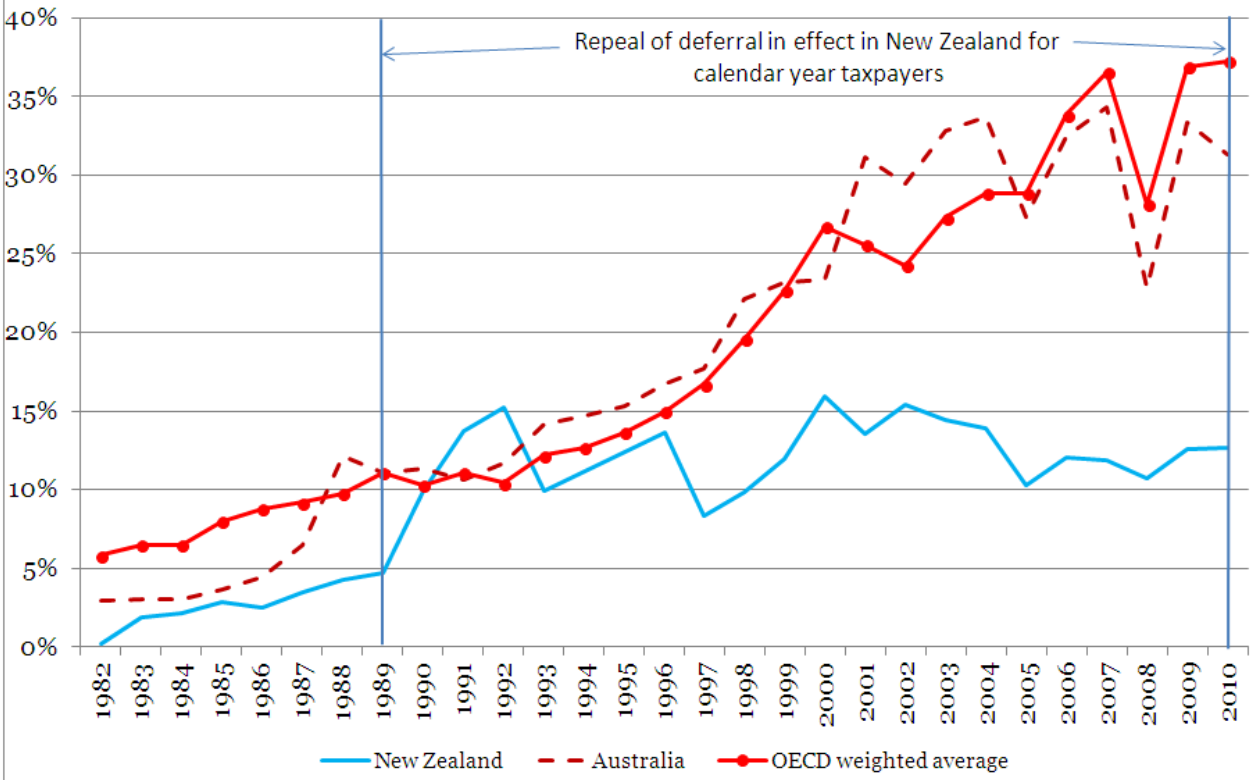
In addition, some countries have increased the scope of the territorial tax system to include additional types of entities or additional types of income. For example, Belgium introduced a participation exemption for foreign-source dividends in 1962, but did not exempt gains on the sale of shares of a foreign subsidiary until 1991.

Figure 1.–Number of Countries with a Territorial Tax System among 34 Current OECD Member Countries, 1891-2011



New Zealand Experience. In 1988, New Zealand departed from the dividend exemption system that had been in effect since 1891, and imposed current taxation on the income of controlled foreign corporations and full taxation of foreign dividends (not previously taxed) with a credit for foreign income taxes. In 1993, the participation exemption system was restored for 8 countries on a "grey list." In 2009, New Zealand restored the dividend exemption system for investments in all countries. One important reason for the change in policy was the loss of international competitiveness. Comparing the first and last five years of the 21-year period (1989-2009) that New Zealand used a worldwide tax system, outbound foreign direct investment as a share of GDP grew by only 7 percent in New Zealand, as compared to a 155 percent increase in Australia and a 198 percent increase in all OECD countries on a weighted average basis (see **Figure 2**).

Figure 2. Outbound FDI Stock as a percent of GDP, 1982-2010
New Zealand, Australia, and the OECD



Source: UNCTAD. Weighted average based on 2010 GDP from the IMF, *World Economic Outlook*, April 2012.

Table 3.–Examples of Countries that have Broadened the Scope of their Territorial Tax Systems

Country	Year	Major Changes in Scope
Australia	2004	Made exemption available to subsidiaries in all countries. Previously had been limited to subsidiaries in listed countries.
Belgium	1988	Increased exemption percentage from 90% to 95%
Czech Republic	2006 and 2008	Made exemption available to additional countries (Switzerland and treaty countries), previously only available to EU members. Also reduced minimum ownership percentage and minimum holding period.
Estonia	2007-2009	Minimum ownership percentage reduced first from 20% to 15% and then to 10%.
Italy	2004	Prior to 2004, 95% exemption only applied to subsidiaries in EU countries. 60% exemption applied to all other non-"black list" countries. In 2004, exemption increased to 95% for all non-"black list" countries.
Luxembourg	1978	Exemption percentage increased from 50% to 100%
Netherlands	1931	Repealed minimum ownership requirement and increased exemption percentage. Ownership requirement was later reintroduced but at significantly lower level.
Norway	various	Various changes to "white list" (countries eligible for exemption) and "black list" (low-tax countries not eligible for exemption).
Portugal	2001	Exemption percentage increased from 95% to 100%
	2002	Minimum holding period reduced from 2 years to 1 year.
	2007	Exemption extended to Portuguese-speaking African countries (previously had applied only to EU member countries).
	2010	Exemption extended to subsidiaries in Iceland, Liechtenstein and Norway
Sweden	2005	Prior to 2005, exemption only applied to dividends to a Swedish "aktiebolag" (Swedish limited liability company). In 2005, this requirement was removed for subsidiaries in EU member countries.
Switzerland	2011	Minimum ownership percentage was reduced

Note: Table is not a complete list of all changes to the territorial tax systems in the listed countries. In addition, some countries that have made changes that have increased the scope of their territorial tax system may also have made changes limiting the scope.
Table refers to treatment of dividends from foreign subsidiaries out of active business income. Countries may also have expanded the types of foreign earnings eligible for exemption.

Examples of countries that have narrowed the scope of their territorial tax systems are shown in **Table 4**. Belgium, Estonia, France, Hungary, and Slovenia have adopted limitations on their territorial exemption systems to exclude dividends from certain low-tax countries. In 1972, Canada limited its exemption system to countries with which it has income tax treaties; however, it subsequently broadened its exemption system to include countries with which it has tax information exchange agreements. A few countries have increased minimum share ownership or holding period requirements.

As noted above, two countries repealed their territorial tax systems at some point (Finland in 1990 and New Zealand in 1988); however, both countries subsequently reinstated their exemption systems.

Table 4.– Examples of Countries that have Narrowed the Scope of their Territorial Tax Systems

Country	Year	Major Changes in Scope
Austria	1989	Dividends from subsidiaries with more than 25% passive income were excluded from the participation exemption. There have been other increases and decreases in the scope of countries covered by the exemption over time.
Belgium	2002	Introduced "black list" of countries that have significantly more advantageous tax systems and are no longer eligible for exemption. A similar change was introduced in 1989 but repealed in 1991. Belgium has also changed ownership requirements (both increasing and decreasing scope) at various times.
Canada	1972	Reduced scope of countries eligible for exemption to treaty countries (previously subsidiaries in all countries were eligible). In 2008, exemption was extended to countries which have signed Tax Information Exchange Agreements with Canada.
Estonia	2007/2008	Participation exemption no longer applies to dividends received from low tax territories (countries with tax rate less than 7%).
Finland	1990	Territorial tax system was repealed, but was reinstated in 2005.
France	2009	Introduced "black list" of countries that have significantly more advantageous tax systems and are no longer eligible for exemption.
Hungary	1997	Introduced new CFC rule which disallowed exemption for dividends from subsidiaries in countries with a tax rate of 10% or less. New rules did not apply to treaty countries.
Luxembourg	1997	Reduced minimum ownership percentage, but introduced minimum holding period and minimum investment requirement
New Zealand	1988/1993	New rules effectively repealed territorial tax system. These rules were repealed in 2009, reinstating the territorial tax system.
Norway	2008	Exemption percentage reduced to 97%. In 2012, the exemption percentage increased to 100% for subsidiaries in EU countries, Iceland, Liechtenstein and Norway that were more than 90% owned. Exemption percentage remains at 97% for all other
Slovenia	2007	Introduced "black list" of countries that have significantly more advantageous tax systems and are no longer eligible for exemption.

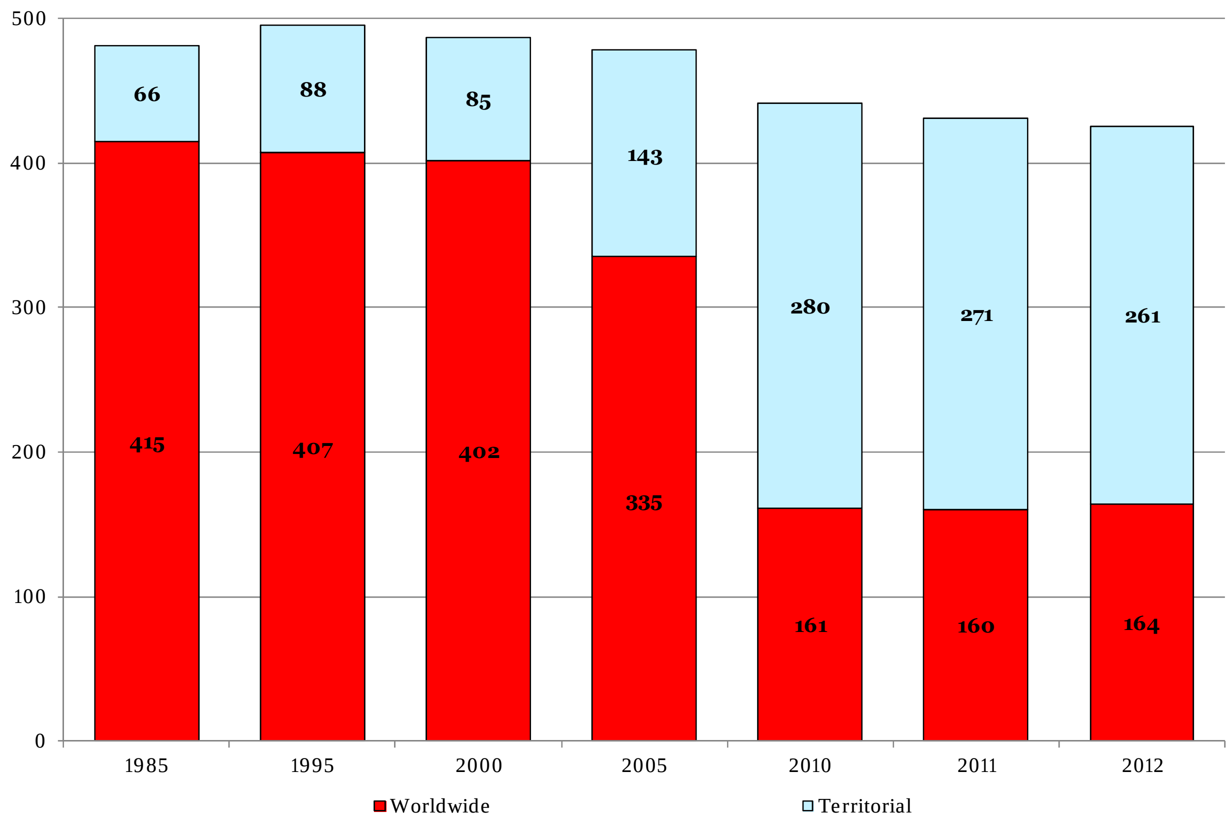
Note: Table is not a complete list of all changes to the territorial tax systems in the listed countries. In addition, some countries that have made changes that have decreased the scope of their territorial tax system may also have made chnages increasing the scope.
Table refers to treatment of dividends from foreign subsidiaries out of active business income.

IV. *Economic Significance of Territorial Countries*

As the number of advanced economies with territorial tax systems has increased over time, a growing share of companies that compete with US multinationals are resident in OECD countries that exempt active foreign earnings under territorial tax systems.

In 2000, only 85 (17 percent) of the world's largest OECD-based companies on the Forbes 500 list were headquartered in countries with territorial tax systems. By 2012, 261 (61 percent) of the world's largest OECD-based companies on the Forbes 500 list were headquartered in countries that have territorial tax systems (see **Figure 3**).

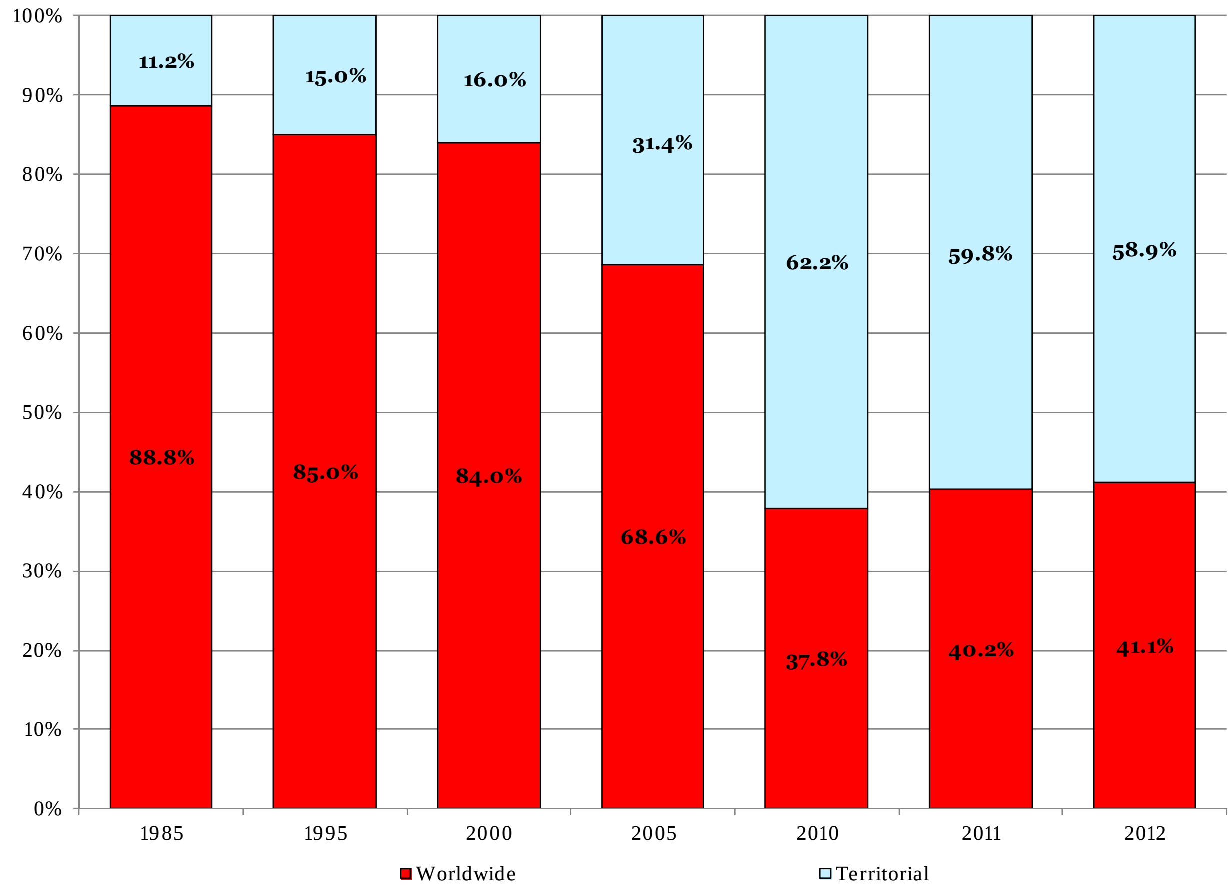
Figure 3.–Number of OECD-Headquartered Companies on Forbes 500 List, Countries with Worldwide and Territorial Tax Systems



Source: Forbes 500, Forbes International 500, and Forbes Global 2000, various years
Note: Year refers to the year of publication.

Similarly, in 2000, 16 percent of sales of the world's largest OECD-based companies on the Forbes 500 list were from companies headquartered in countries with territorial tax systems. By 2012, 59 percent of the sales of the world's largest OECD-based companies on the Forbes 500 list were from companies headquartered in countries that have territorial tax systems (see **Figure 4**).

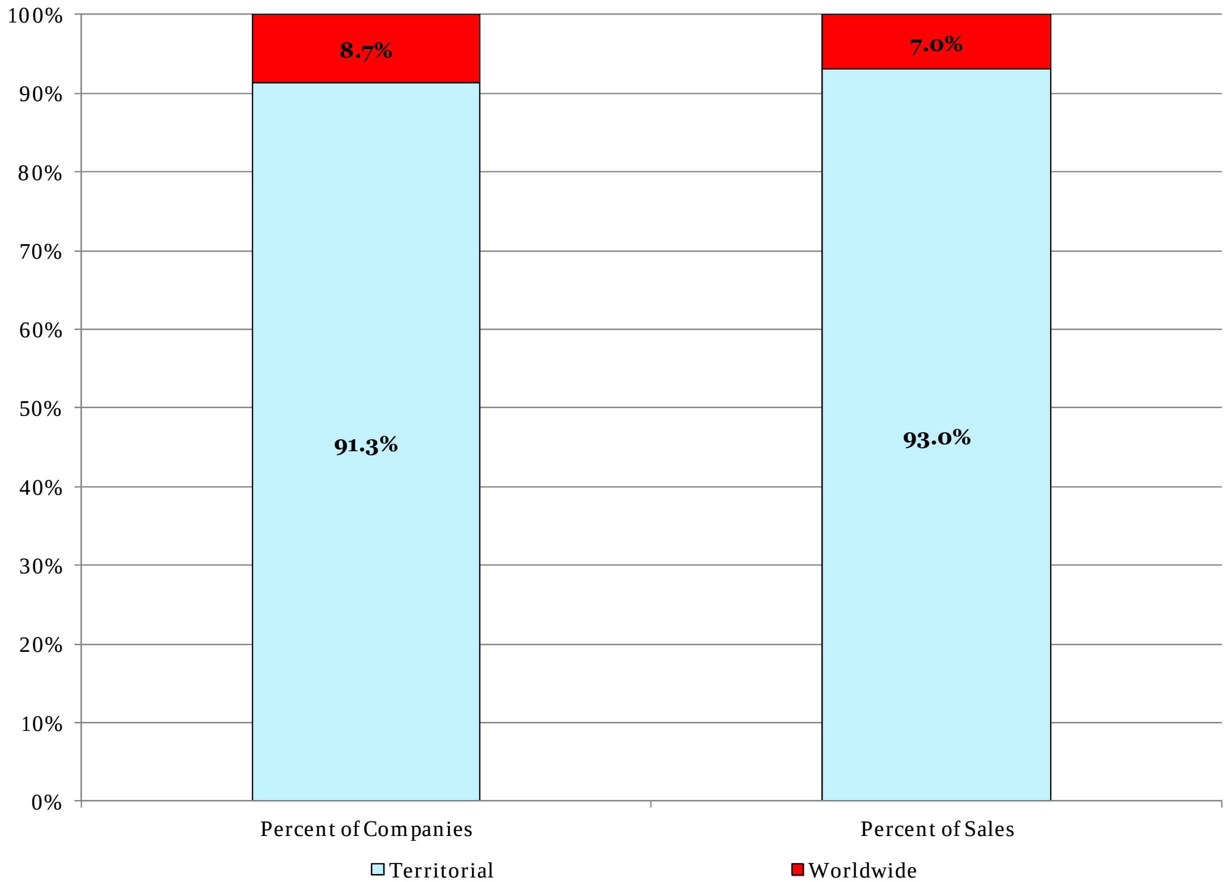
Figure 4.–Sales of OECD-Headquartered Companies on Forbes 500 List; Share in Worldwide and Territorial Tax Countries



Source: Forbes 500, Forbes International 500, and Forbes Global 2000, various years
Note: Year refers to the year of publication.

Today, nearly all of the competitors of US companies from OECD countries are headquartered in territorial tax countries. In fact, 91 percent of the non-US OECD-headquartered companies on the Forbes 500 list of the world's largest companies for 2012 were headquartered in countries with a territorial tax system. Similarly, 93 percent of the sales of non-US OECD-headquartered companies on the Forbes 500 list were from companies headquartered in countries with a territorial tax system (see **Figure 5**).

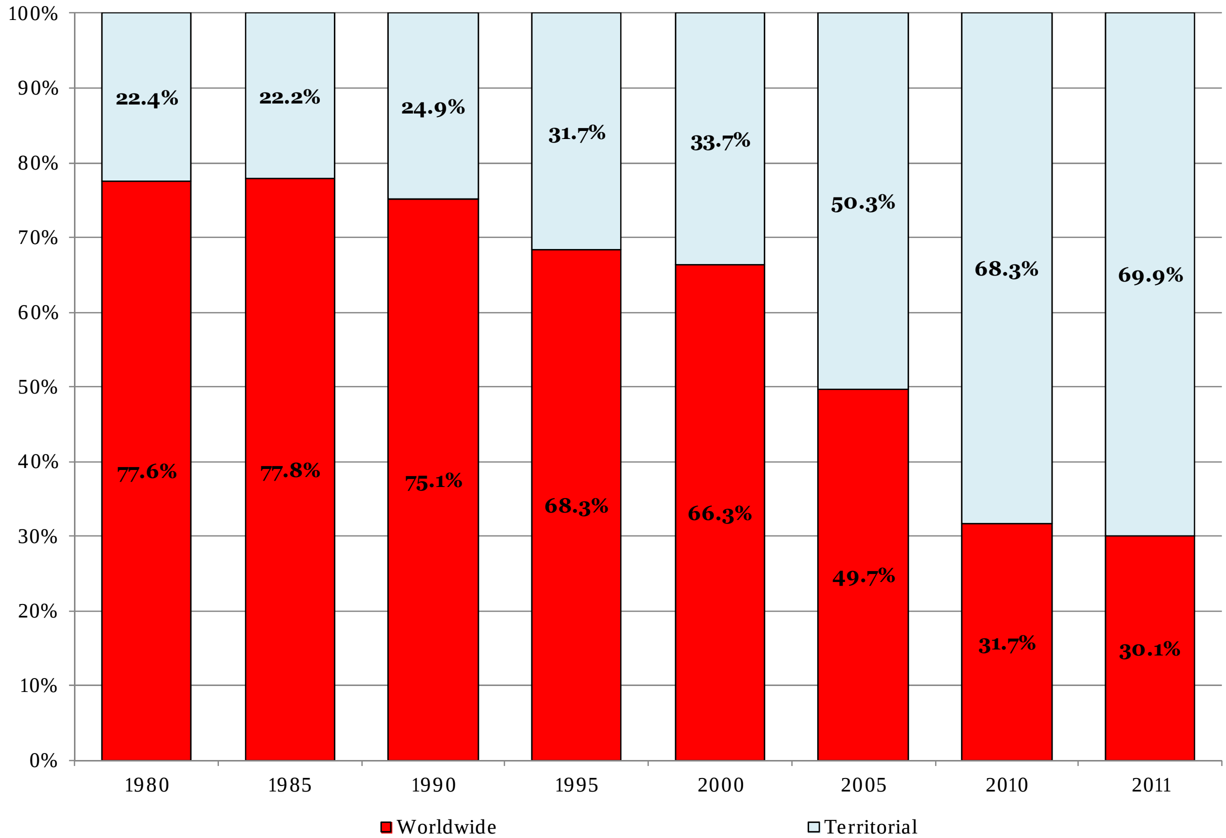
Figure 5.–Non-US OECD-Headquartered Companies on the Forbes 500 List for 2012, Share in Territorial and Worldwide Countries



Source: Forbes 500, Forbes International 500, and Forbes Global 2000, various years
Note: Year refers to the year of publication.

The growing significance of multinational companies based in territorial jurisdictions also can be seen from the share of outbound foreign direct investment (FDI) from OECD countries that comes from countries with territorial tax systems. In 1980, 22.4 percent of the total stock of outbound FDI from OECD countries came from countries with territorial tax systems, compared to 69.9 percent in 2011 (see **Figure 6**).

Figure 6.–Outbound Stock of Foreign Direct Investment from Worldwide and Territorial Tax Countries - Percent of Total OECD Outbound Stock



Source: PwC calculations based on data from UNCTAD.

In summary, just a decade ago, most of the world's largest companies were located in countries with worldwide tax systems. Today most of the competitors of US companies from OECD countries are headquartered in territorial tax countries. These companies account for the majority of the sales of the companies on the Forbes 500 list and the majority of outbound foreign direct investment in the OECD. Today, over 90 percent of the OECD-based companies on the Forbes 500 list with which US companies compete are headquartered in territorial tax countries.