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State Tax Research Institute

Survey of Subnational Corporate Income Taxes in Major World Economies: Treatment of Foreign Source Income

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NOVEMBER 2019

ABOUT STRI

The State Tax Research Institute (STRI) is a 501(c)(3) organization established in 2014 to provide educational programs and conduct research designed to enhance public dialogue relating to state and local tax policy. STRI is affiliated with the Council On State Taxation (COST). For more information on STRI, please contact Douglas L. Lindholm at dlindholm@cost.org.

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MESSAGE FROM THE PRESIDENT

The Council on State Taxation (COST) and our research affiliate, The State Tax Research Institute (STRI), have long been committed to increasing the body of knowledge and enhancing public dialogue relating to the state and local taxation of business entities. We are pleased to present our latest contribution to that effort "Survey of Subnational Corporate Income Taxes in Major World Economies: Treatment of Foreign Source Income" by PwC's National Economics and Statistics group.

The debate over whether states in the United States should include foreign source income in the corporate income tax base has simmered over the past three decades. Since the mid-1980s, states have generally followed the "water's-edge" principle, including in their corporate income tax bases income earned from domestic sources and not from foreign sources.

There have been some notable exceptions to this model. For instance, a small number of states—about one-seventh of the states with corporate income taxes—have included (or potentially included on audit) income earned by foreign subsidiaries in so-called "tax haven countries" in their tax base. A larger minority of states—about one-third of all states—have included a portion of foreign dividends (generally 25% or less) paid by foreign subsidiaries in their corporate income tax base.

More recently, some of the states have conformed, in part, to Global Intangible Low-Taxed Income ("GILTI")—a provision in the 2017 federal tax reform legislation (the Tax Cuts & Jobs Act) that adds a new category of foreign source income to the corporate income tax base. At the state level, about two-fifths of all states include a portion (typically 15% to 50%) of GILTI in their tax base. However, among the states with the largest economies, all except for New Jersey have decoupled from the federal provision and do not tax GILTI (or exempt 95% of it).

The PwC study adds an important international perspective to the issue of whether subnational governments should tax foreign source income. The study concludes that the governments of virtually all major foreign economies either choose not to levy subnational corporate income taxes, or if they do, choose not to include foreign source income in the subnational tax base. The study focuses on the 48 countries (other than the United States) that are members of either the Organization for Economic Cooperation and Development ("OECD") or the Group of 20 ("G20"). Together with the United States, these countries represent nearly 90 percent of global gross domestic product.

The PwC study has two primary findings. The first finding is that only eight of the 48 non-U.S. members of either the OECD or G20 impose some form of subnational (regional or municipal) corporate income tax. The second finding is that among these eight countries, only in one country, South Korea, is more than a de minimis amount of foreign source income included in the subnational corporate income tax base. In the other seven countries, active foreign source income is either not included in the subnational corporate income tax base or is eligible for a 95% or 100% exemption. These findings in the PwC study should be valuable to state policymakers as they address whether the state corporate income tax base should include any foreign source income.

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November 2019

Prepared for:

State Tax Research Institute

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PwC was engaged by the State Tax Research Institute to determine which member countries of either the Organization for Economic Cooperation and Development ("OECD") or the Group of 20 ("G20") have subnational (e.g., regional or municipal) corporate income taxes ("CITs").[1] These countries represent nearly 90 percent of global gross domestic product. This report provides a summary of the results of this survey of the 48 countries[2] (excluding the United States) that are members of the OECD or G20. In each of the 48 countries, we examine whether a corporation operating in the largest city in each country is subject to a subnational CIT.[3] For those countries with subnational CITs, the report provides an analysis of the corporate tax base and tax rates at the regional and/or municipal levels. Among the features of the subnational CITs we examine is whether foreign source income is subject to tax.

In the United States, 44 states (plus the District of Columbia) levy state-level corporate income taxes. Of the 48 member countries, eight have subnational governments that impose some form of subnational CIT. In the jurisdictions examined within each of these eight countries, two countries have jurisdictions that levy separate regional- and municipal-level corporate income taxes (Lisbon, Portugal and Zurich, Switzerland), two countries have jurisdictions that levy only a regional-level corporate income tax (Ontario, Canada and Lombardy, Italy), three countries have jurisdictions that levy only a municipal-level corporate income tax (Tokyo, Japan; Luxembourg City, Luxembourg; and Seoul, South Korea), and one country has a municipal-level corporate income tax where the municipality is also equivalent to a region (Berlin, Germany).[4]

Among these eight countries, only in one country, South Korea, is active foreign source income subject to full subnational taxation (at a maximum rate of 2.5 percent). In the other seven countries, foreign source income is either not subject to tax or is eligible for a participation exemption, under which either 100 percent or 95 percent of foreign source income is exempt from taxation. Further, should the particular income not qualify for the participation exemption system of the country (for example, due to insufficient ownership in the entity paying a dividend), tax on foreign source income may be reduced by foreign tax credits in several of the countries. Of the eight countries that tax corporate income at the subnational level, five countries include in the subnational tax base certain passive income earned by foreign subsidiaries under controlled foreign corporation ("CFC") rules established under national law (typically income from passive investments, which may include interest, royalties, capital gains, and certain dividends on portfolio investments).

The survey findings for each of the eight countries with subnational CITs are summarized in **Table 1** and discussed below.

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[1] For purposes of this study, a CIT is defined as an income tax that would conceptually qualify for double tax treaty relief. For example, the subnational business tax levied by municipalities in Hungary is not considered a CIT for this purpose because it is similar to a gross receipts tax with limited deductions and is not treated as an income tax in the application of tax treaties.
[2] The 48 countries are listed in the appendix.
[3] For Italy, the report provides information for Lombardy, which contains the second largest city (Milan), because it is the region where business is concentrated in Italy.
[4] In this respect, Berlin is analogous to Washington, DC.

Subnational CIT Rates

Of the 48 member countries, eight have subnational governments that impose some form of subnational CIT either at the regional level (e.g., province, region, district, or canton) and/or municipal level. Subnational CIT rates vary from as little as 2.5 percent in South Korea to over 14 percent in Germany and Switzerland.[5] Though Switzerland has the highest rate of subnational taxes, a relatively low national rate results in the lowest combined corporate income tax rate among the eight countries with subnational CITs (21.15 percent).[6]

Subnational CIT Base

In most of the countries with subnational CITs, the base for subnational taxation is the same or nearly the same as at the national level. One exception is Italy, where the subnational tax base excludes items of income or loss relating to financial investments or financial transactions. These financial items include, among others, dividend income, interest income, interest expenses, and capital gains or losses from disposal of shares. In South Korea and Switzerland, subnational jurisdictions are permitted to have different tax bases from each other, with the result that there may be some variation between the tax base at the national level and the tax base in any particular subnational jurisdiction in those countries.

Active foreign-source income

Among the eight countries with subnational CITs, active foreign-source income, defined as dividends from foreign subsidiaries and capital gains on sale of shares in foreign subsidiaries, is generally fully or partially exempt from subnational taxation under "participation exemption" rules. Under a participation exemption system, a domestic parent company is entitled to a deduction from income ("exemption") for dividends received from foreign subsidiaries in which the parent's ownership ("participation") is sufficiently high. A 100-percent exclusion applies to income qualifying for participation exemption in Canada, Luxembourg, and Portugal, and near a full exemption in Switzerland.[7] A 95-percent exclusion applies to income qualifying for participation exemption in Germany and Japan. Foreign tax credits are permitted to offset subnational CIT on income that fails to qualify for the participation exemption systems in Canada, Japan, Portugal, and Switzerland.[8] In Italy, active foreign source income is excluded from taxation given the exclusion for financial items (including dividends, interest, and capital gains) from the subnational tax base. Only in South Korea, which has a worldwide tax system, is active foreign-source income generally subject to full taxation.

Passive foreign-source income

Of the eight countries with subnational CITs, five countries—Canada, Germany, Japan, Portugal, and South Korea—include in the subnational tax base the passive foreign-source income of corporations that is taxed at the national level under a CFC regime. The CFC regimes are intended to tax on a current basis certain passive income earned by CFCs, similar to Subpart F rules in the United States. Passive income may include interest, royalties, capital gains, and certain dividends from portfolio investments. The three countries with subnational corporate income taxes that do not tax passive foreign-source income at the subnational level are Italy, Luxembourg, and Switzerland.

[5] Rates are as of July 1, 2019.

[6] Tax reform enacted by Switzerland lowers cantonal taxes effective January 2021.

[7] In Switzerland, 100-percent participation relief applies to net participation income, which may be less than gross income due to recaptured depreciation and certain other expenses.

[8] Factors that may cause income to fail to qualify for a country's participation exemption system include the absence of a treaty with the country in which the income is earned, share ownership below a specified level, or shares held less than a specified duration.

Table 1.—Survey of Subnational Corporate Income Tax in G20 and OECD Countries excluding the United States

Country	Canada	Germany	Italy	Japan	Luxembourg	Portugal	South Korea	Switzerland
Subnational government[1]								
Taxing authority	Province of Ontario	Municipality of Berlin	Region of Lombardy	Tokyo Metropolitan Government	Luxembourg City	Lisbon District and Municipality	Seoul Metropolitan Government	Zurich Canton and City
Level of subnational government levying tax	Regional	Regional - Municipal (Berlin is both a region and a municipality)	Regional	Municipal	Municipal	Regional and municipal	Municipal	Regional and municipal
Rate (as of July 1, 2019)[2]								
Subnational tax rate (prior to deduction against national CIT, if applicable)	11.5%	14.35%	3.9%	12.6%	6.75%	District 9.0% City 1.5%	2.5%	Canton 6.3% City 8.1%
National CIT rate	15.0%	15.825%	24.0%	23.2%	18.19%	21%	25%	8.5%
Combined subnational and national CIT rate	26.5%	30.175%	27.8%	34.6%	24.94%	31.5%	27.5%	21.15%
Base								
Same as national base?	Yes, generally[3]	No	No; however, both bases are determined by the Italian Parliament.	Yes	Yes	Yes	Yes, generally	No[4]

[1] Jurisdictions were chosen in which the largest city in each country is located. Other jurisdictions within each country may levy similar taxes. For Italy, Lombardy, which contains the second largest city (Milan), was chosen because it is the region where business is concentrated. The subnational government shown is the level at which tax is assessed. In some jurisdictions corporate income tax is levied by both regional-level and municipal-level governments while in other jurisdictions it is levied by either the regional- or municipal-level government.
[2] In cases in which graduated rates apply, the highest applicable rate is shown.
[3] While all provinces have the ability to determine their own tax policy and legislate their own tax rules, the Federal and subnational tax bases are aligned to simplify tax administration. All provinces except Alberta and Quebec have signed tax collection agreements with the Canada Revenue Agency to administer the corporate income tax.
[4] Certain tax regimes that may result in different income tax bases at the Federal and cantonal/communal level will be abolished once recently enacted tax reform becomes effective on January 1, 2020. The major differences noted below refer to reductions in the subnational tax base

Country	Canada	Germany	Italy	Japan	Luxembourg	Portugal	South Korea	Switzerland
Major differences between national and subnational base?	Minimal	Examples, of which there are others, subnational CIT: adds back a portion of deductions for interest, rent, royalties taken at the national level; deducts 1.2% of taxable value of certain real estate.	Commercial and industrial companies: (i) financial revenues and expenses are excluded from subnational CIT; (ii) certain personnel expenses are partially not deductible from subnational CIT; (iii) capital gains or losses from disposal of going concerns are excluded from subnational CIT. Different rules may apply to companies in other industries.	Tax consolidation applicable for national purposes only.	None	None	Some tax attributes such as tax exemptions and credits may differ.	Subnational governments may provide patent box regime, research and development super deduction, and notional interest deduction.
Base same for all subnational governments?	Yes	Yes	Yes	Yes	Yes	Yes	No	No

relative to the Federal tax base that may be available as of January 1, 2020. Certain transitional measures for companies that benefited from abolished regimes may result in tax base differences for a limited period of time after December 31, 2019.

Country	Canada	Germany	Italy	Japan	Luxembourg	Portugal	South Korea	Switzerland
Treatment of foreign-source income								
Active income (dividends and capital gains from a foreign subsidiary)	Taxable, subject to participation exemption.	Taxable, subject to participation exemption.	Not taxable	Taxable, subject to participation exemption.	Taxable, subject to participation exemption.	Taxable, subject to participation exemption.	Taxable	Taxable subject to participation exemption.
Participation exemption at national level also applicable at subnational level?	Yes, 100% exemption	Yes, with additional requirements (e.g., 15% vs, 10% ownership threshold to qualify); 95% exemption, 5% subject to tax	N/A, financial income excluded from subnational tax base	Yes, 95% exemption, 5% subject to tax	Yes, 100% exemption	Yes, 100% exemption	N/A, no participation exemption	Yes, near full exemption
Foreign tax credit at the subnational level?	Available only to the extent not fully credited by the Federal government	No	No	Yes	No	Yes	No	Yes
Treatment of passive foreign income taxed at the national level under a CFC-type regime								
	Taxable	Taxable	Not taxable	Taxable	Not taxable	Taxable	Taxable	N/A (no national level CFC regime)

Appendix: List of 48 Members of the OECD or G20, excluding the United States

Argentina	**Germany***	New Zealand
Australia	Greece	Norway
Austria	Hungary	Poland
Belgium	Iceland	**Portugal***
Brazil	India	Romania
Bulgaria	Indonesia	Russian Federation
Canada*	Ireland	Saudi Arabia
Chile	Israel	Slovak Republic
China	**Italy***	Slovenia
Croatia	**Japan***	South Africa
Cyprus	Latvia	**South Korea***
Czech Republic	Lithuania	Spain
Denmark	**Luxembourg***	Sweden
Estonia	Malta	**Switzerland***
Finland	Mexico	Turkey
France	Netherlands	United Kingdom

* Eight countries shown in bold font have subnational governments that impose a subnational corporate income tax.

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