PERSPECTIVES ON THE CORPORATION TAX

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Taxation principles: Neutrality

Neutrality criterion

In a federation, common market or global world businesses should be able to source anywhere, manufacture anywhere and sell anywhere without being hampered by double taxation and discrimination issues arising under corporation taxes (CTs)

- ✓ Requires substantial degree of tax harmonization

Taxation principles: Tax sovereignty

Tax sovereignty

CTs should be levied in line with policy preferences of individual countries or states

- ✓ Implies tax diversity although harmful tax competition should presumably be avoided

- ➢ Combining two principles: As much diversity should be permitted as is possible without interfering with cross-border trade and investment

How can corporate source income be taxed?

1. Taxing profits = return on equity
2. Taxing capital income = return on equity and debt
3. Taxing economic rents = above-normal return on capital

- Normal or hurdle rate of return to capital is the return that makes an investment just worthwhile; usually taken to equate world rate of interest

Taxing profits

Classical vs. full integration system

- *classical system* involves economic double taxation of corporate profits, distributed and retained
- *full integration* allocates all corporate source income to individual shareholders and taxes it at their level

Dividend relief systems

- *imputation system* imputes CT to dividend distribution
- *dividend-deduction system* treats dividends on a par with interest
- *split-rate system* applies lower CT rate to dividend distributions
- *ad hoc approaches* apply a lower personal income tax (PT) rate to dividends or partially exempt dividends

Taxing capital income

1. *Dual income tax* (DIT) separates capital income from labor income and applies a low flat rate to capital income, while taxing labor income at progressive rates
2. *Comprehensive business income tax* (CBIT) does not permit a deduction of interest in ascertaining taxable profits

Main features of dual income tax (1)

1. Separation of capital and labor income
2. Capital taxed at low, uniform rate; labor income taxed at progressive rates; capital income tax rate = rate applied to lowest labor income tax bracket
3. Costs of earning income only deductible against income in first bracket; no basic allowance for capital income
4. Negative capital income can be offset against labor income at capital income tax rate

Main features of dual income tax (2)

5. Double taxation of dividends prevented by exempting dividend income; double taxation of retained profits prevented by write up of acquisition costs of shares by retained profits net of tax
6. Withholding taxes on interest or royalties set at level of corporation tax rate; can be final
7. Profits of proprietorships and closely-held companies in which labor and capital income accrue jointly should be split

Main difference between DIT and CBIT

- DIT’s withholding tax is not necessarily same as CT rate as it is implicitly under CBIT. This permits greater flexibility and fewer potential conflicts with other countries
- DIT permits gradual transformation to CBIT

Taxing economic rents

1. ***Cash-flow*** or ***flat tax*** permits immediate expensing of investments but claws back interest; proposed in US

Flat tax: base equals sales minus purchases (= value added) minus wages = business cash flow = above-normal profits

2. ***Allowance for corporate equity*** (ACE) permits a deduction from profits of normal return on equity; proposed by IFS, found in Belgium and Italy

Allowance: equals (presumptive) normal rate of return on equity

3. ***Rate of return allowance*** (RRA) extends ACE to all forms of capital income; proposed by Mirrlees

Comparative evaluation

- Should the normal return to capital be taxed or not? That's the question!
- If yes, should interest (and royalties perhaps) be taxed on a par with profits at the corporate level?
- The choice is yours!