THE CORPORATE INCOME TAX: INTERNATIONAL TRENDS AND OPTIONS FOR FUNDAMENTAL REFORM

Professor Peter Birch Sørensen
Department of Economics
University of Copenhagen

Presentation at the DG Economic and Financial Affairs Workshop on Corporate Tax Competition and Coordination in Europe in Brussels, September 25th, 2006
AGENDA

• International trends in corporate taxation

• Alternative blueprints for fundamental capital income tax reform in the open economy

• Comparing alternative options for reform
DECOMPOSING THE RATIO OF CORPORATE TAX REVENUE TO GDP

\[
\frac{R}{Y} \equiv \frac{R}{C} \cdot \frac{C}{P} \cdot \frac{P}{Y}
\]

\[R = \text{corporate tax revenue}\]
\[Y = \text{GDP}\]
\[C = \text{total profits in the corporate sector}\]
\[P = \text{total profits bill}\]
THE ISSUE

How can individual countries best adapt their corporate tax systems in a world of growing capital mobility, and at the same time minimize the traditional tax distortions to investment and financing decisions?
## ALTERNATIVE SYSTEMS OF CAPITAL INCOME TAXATION

<table>
<thead>
<tr>
<th>Location of tax base</th>
<th>Type of income subject to business tax</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Source country</strong></td>
<td>Full return to equity 1. Conventional corporate income tax with exemption of foreign source income</td>
</tr>
<tr>
<td></td>
<td>Full return to capital 4. Dual Income Tax; 5. Comprehensive Business Income Tax</td>
</tr>
<tr>
<td></td>
<td>Rent 6. Corporation tax with an Allowance for Corporate Equity; 7. Source-based cash flow corporation tax</td>
</tr>
<tr>
<td>Residence country of corporate head office</td>
<td>2. Residence-based corporate income tax with a credit for foreign taxes</td>
</tr>
<tr>
<td>Residence country of personal shareholders</td>
<td>3. Residence-based shareholder tax</td>
</tr>
<tr>
<td>Destination country of final consumption</td>
<td>8. VAT-type destination-based cash flow tax</td>
</tr>
</tbody>
</table>
TAXING THE FULL RETURN TO EQUITY: A RESIDENCE-BASED SHAREHOLDER TAX?

Pros:
● Full neutrality between corporate and non-corporate firms
● Full neutrality across different modes of finance
● Individuals are less mobile than capital

Cons:
● Liquidity problem for shareholders who do not receive dividends
● Difficult to impute retained profits in foreign companies to domestic holders of foreign shares
TAXING THE FULL RETURN TO EQUITY: A RESIDENCE-BASED CORPORATION TAX?

Pros:
● Source taxation unnecessary for ’backstop’ function of the corporation tax
● Increased incentive for inward investment
● Capital export neutrality (elimination of deferral)

Cons:
● Difficult to enforce domestic tax on profits retained abroad
● Easy to move company headquarters abroad
TAXING RENTS:
A DESTINATION-BASED CASH FLOW TAX?

Tax base: Domestic sales minus purchases from domestic suppliers (VAT base) minus labour costs

Pros:
● No distortion to investment and location decisions
● No transfer-pricing problem

Cons:
● Transition problem (need for real appreciation, anticipation effects)
● Anticipation effects and windfall gains and losses in case of changes in tax rates
TAXING RENTS:
A SOURCE-BASED CASH FLOW TAX?

Tax base: Domestic and foreign sales minus purchases from domestic and foreign suppliers minus labour costs. For related foreign entities, financial cash flows are also included (Bradford scheme)

Pros:
- Exempts the normal return but captures location-specific rents, including rents accruing to foreigners
- In principle, the Bradford scheme solves the transfer pricing problem

Cons:
- Distorts location decisions in case of mobile rents
- Distorts investment decisions in case of anticipated tax rate changes
- Transition problem for heavily indebted firms
TAXING RENTS: AN ALLOWANCE FOR CORPORATE EQUITY?

Tax base: Profits minus interest minus imputed return to equity

Pros:
- Financial neutrality
- Offsets distortions from accelerated depreciation
- Eliminates need for thin capitalization rules
- No transition problem or problem with anticipation effects

Cons:
- Distortions if the imputed return is set at 'wrong' level
- May require high statutory tax rate, thus exacerbating transfer pricing problem
TAXING THE FULL RETURN TO CAPITAL: THE COMPREHENSIVE BUSINESS INCOME TAX

**Tax base:** Profits before interest

**Pros:**
- Financial neutrality
- Broad base allows low tax rate, thus reducing the transfer-pricing problem and benefiting the most profitable companies

**Cons:**
- Transition problem for indebted companies
- Significant increase in the cost of debt capital
TAXING THE FULL RETURN TO CAPITAL: THE DUAL INCOME TAX

The DIT: Flat uniform tax on capital income and corporate income combined with progressive tax on labour income. Capital income tax collected at source, but withholding taxes on foreign investors may be waived. Double taxation of corporate income may be fully alleviated.

Pros:
- Capital income tax rates can be kept low, to reduce distortions and capital flight

Cons:
- Need to split the income from small enterprises into labour income and capital income

Norwegian solution: A neutral shareholder income tax on the equity premium
## ALTERNATIVE OPTIONS FOR REFORM: SUMMING UP

<table>
<thead>
<tr>
<th>Distortion to</th>
<th>Reform proposal addressing distortion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Choice between debt and equity</td>
<td>ACE, Cash flow tax, CBIT, DIT, Residence-based shareholder tax</td>
</tr>
<tr>
<td>Choice between new equity and retained earnings</td>
<td>ACE, Cash flow tax, CBIT, DIT, Residence-based shareholder tax</td>
</tr>
<tr>
<td>Choice of organizational form</td>
<td>ACE, Cash flow tax, CBIT, DIT, Residence-based shareholder tax</td>
</tr>
<tr>
<td>Domestic real investment</td>
<td>ACE, Cash flow tax</td>
</tr>
<tr>
<td>International location of real investment</td>
<td>Residence-based shareholder tax, Residence-based corporate income tax, VAT-type destination-based cash flow tax</td>
</tr>
<tr>
<td>International location of tax base (transfer pricing)</td>
<td>Residence-based shareholder tax, Residence-based corporate income tax, VAT-type destination-based cash flow tax</td>
</tr>
</tbody>
</table>