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

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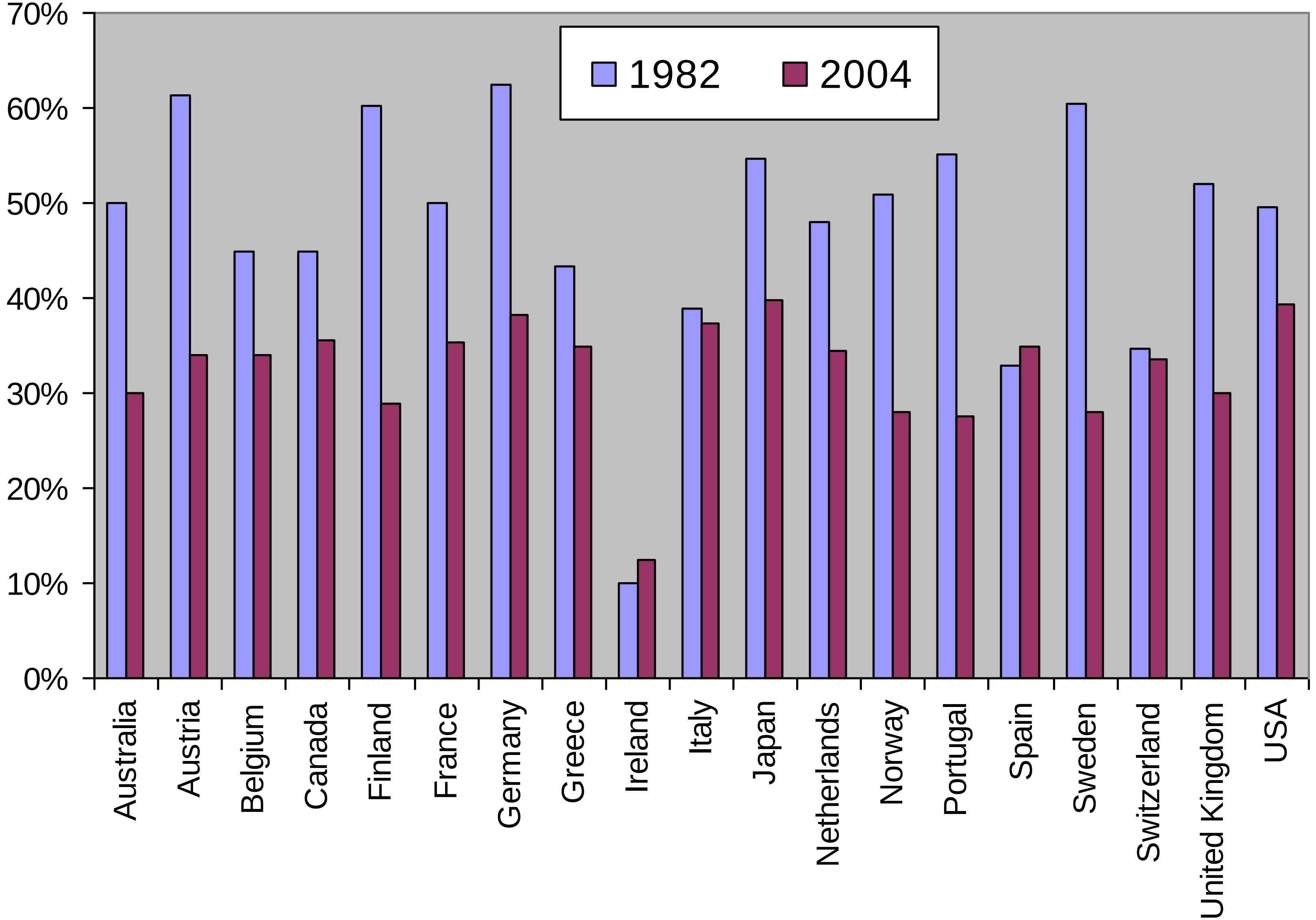
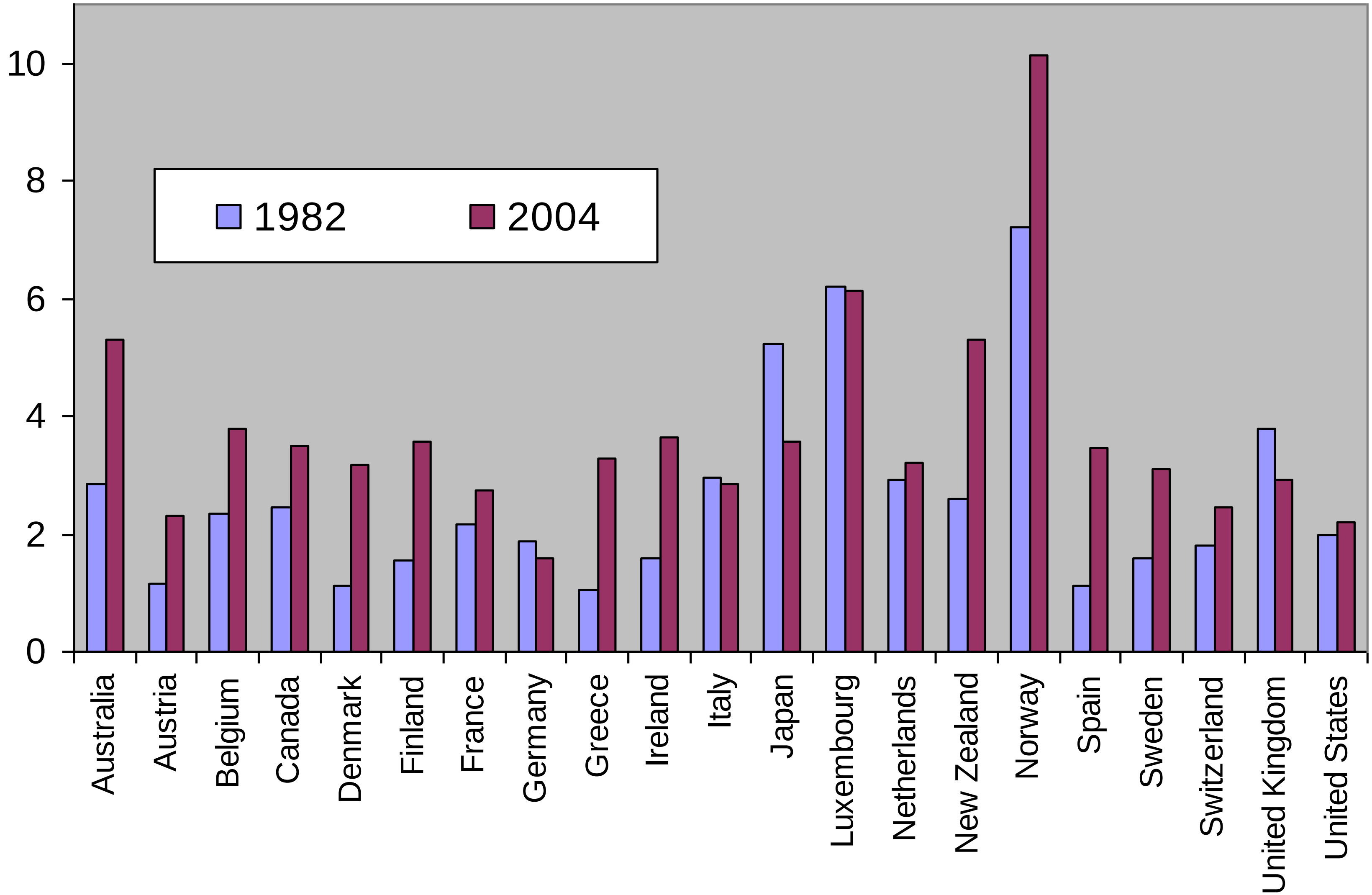
AGENDA

- International trends in corporate taxation
- Alternative blueprints for fundamental capital income tax reform in the open economy
- Comparing alternative options for reform

STATUTORY CORPORATE TAX RATES 1982 AND 2004



CORPORATE TAX REVENUE (% OF GDP)



DECOMPOSING THE RATIO OF CORPORATE TAX REVENUE TO GDP

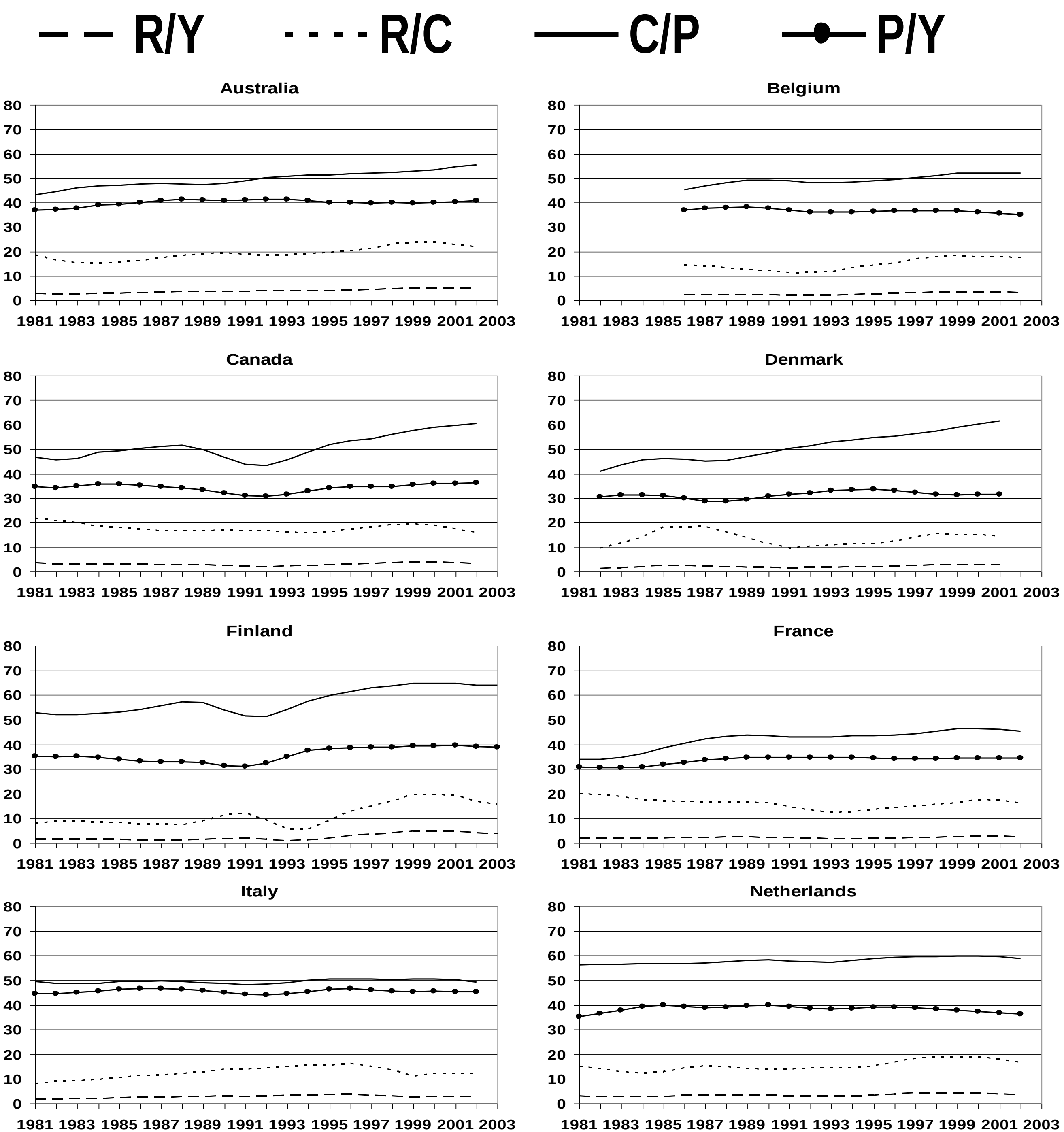
$$\frac{R}{Y} \equiv \frac{R}{C} \bullet \frac{C}{P} \bullet \frac{P}{Y}$$

R = corporate tax revenue

Y = GDP

C = total profits in the corporate sector

P = total profits bill



R/Y
R/C
C/P
P/Y
Australia
Belgium
Canada
Denmark
Finland
France
Italy
Netherlands
0
10
20
30
40
50
60
70
80
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003

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

Location of tax base	**Type of income subject to business tax**		
	Full return to equity	Full return to capital	Rent
Source country	1. Conventional corporate income tax with exemption of foreign source income	4. Dual Income Tax; 5. Comprehensive Business Income Tax	6. Corporation tax with an Allowance for Corporate Equity; 7. Source-based cash flow corporation tax
Residence country of corporate head office	2. Residence-based corporate income tax with a credit for foreign taxes		
Residence country of personal shareholders	3. Residence-based shareholder tax		
Destination country of final consumption			8. VAT-type destination-based cash flow tax

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 waiwed. 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

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