Tax neutrality between CIT and non-CIT subjects: how to improve our systems?

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Introduction. When, where, and at what rate to tax the income of business entities are the fundamental questions for the corporate income tax (CIT). Answers to those questions should remain independent of the taxpayer’s choice of business form, as one may achieve identical revenue outcomes with entity opacity or transparency. When the answers to those questions vary with business form and tax system structure, opportunities to arbitrage those differences across national borders and diminish or avoid tax on the corporate income inevitably emerge.

Tax professionals, administrators, academics, economists, and business participants may and often do disagree on whether a corporation’s (or other business entity’s) income from the operation of its business should be taxable to the corporation itself or taxable to its owners. Opinions also may diverge on whether or not to tax investment income differently from income from the operation of a business. Despite those disagreements, as long there is to be an income tax, all will agree, however, that the choice of one business form rather than another should not result in income from business operations escaping income tax completely.

Similarly, income primarily should be subject to tax where the taxpayer produces income from the operation of a business. Taxing income where the taxpayer’s principal office or seat of management happens to be makes sense only in system that taxes residents and citizens on their worldwide incomes (global models of taxation) but only secondarily to the place of income production in order to prevent taxpayers from gaining an advantage by placing their income in low tax jurisdictions. Those jurisdictions that tax resident corporations on their worldwide incomes cede primary taxing authority to the jurisdiction where the taxpayer produces income. Determining where the taxpayer produces income often is challenging as intellectual property may be in one location, factories in a second location, service employees in a third location, sales in a fourth and all contribute to the production of the taxpayer’s income.

1 Proposals to substitute a consumption tax for an income tax are common, so that in the future an income tax may no longer exist.
3 For example, the U.S. allows a credit against the corporation’s U.S. tax for the tax paid in the jurisdiction of production.
4 The CCCTB Proposal addresses the location problem through formulary apportionment of business income.
This brief thematic report argues that a wholly transparent income tax system would improve existing CIT systems and establish tax neutrality between CIT and non-CIT subjects. Full transparency is consistent with international treaty obligations and simultaneously eliminates many international tax arbitrage opportunities. Business needs rather than tax benefits would drive choice of business form. If accompanied by a robust system of international apportionment of business income, a fully transparent corporate income tax would eliminate most income allocation arbitrage as well as tax system structure arbitrage opportunities.

Some History. The thorough national reports on the CIT disclose no universal policy on imposition of the CIT. Two often converging lines of argument for an entity level tax emerge: i) limited liability and ii) separate personality. Most of the reports identify limited liability as the key factor, and several countries even impose a CIT on the limited partners’ shares of limited partnership income but not on the general partners’ shares. All countries have one or more tax transparent entities including invariably something comparable to a general partnership. Several countries view general partnerships as having no personality separate from their partners.6

Historically, these concepts of separate personality and limited liability led many jurisdictions to tax corporations at rates consistent with individual income tax rates. When the corporations distributed their earnings to their owners, the owners would include the distributions as dividends in their individual incomes subject to the owners’ individual income tax rates. Separation of the entity from its owners for tax purposes caused the aggregate tax on corporate earnings to combine the two levels of tax. If, for example, the maximum income tax rate for all taxpayers was fifty percent, the total tax on distributed corporate earnings would be seventy-five percent, that is, fifty percent at corporate level and fifty percent of the remaining fifty percent (after corporate tax) at shareholder level. This full two level tax is less common today than it was several decades ago.

In the 1940s, objections to the full two levels of tax began to arise and relied on political characterization of the corporate tax system as unjustifiable double taxation. Despite the corporation’s separate personality, it seemed indisputable that the corporate owners economically bore the corporate tax in addition to the shareholder tax so that integration of corporate and shareholder taxes on corporate earnings became economically compelling. Increasingly, however, economic models identify a shift of the incidence of some or all the corporate tax to labor through lower wages and consumers through higher prices. Even the


6 Somewhat unclear is whether no separate personality means that the general partnerships contract in the partners’ names rather than in the partnerships’ names.
staunchest proponents of full separate taxes concede that relief from multiple impositions of the corporate level tax through chains of corporations is desirable. Consolidated returns of income for groups of related corporations and dividend relief for distributions from corporations to corporate owners of their shares have become common.

More recently some countries began to delink the concepts of separate personality and limited liability. Limited liability ceased to be determinative of tax opacity. Rather public trading of ownership interests signaled separateness of personality, so that public companies remained opaque while many closely-held businesses became tax transparent (or the owners could elect transparency for the company).

Increasing economic globalization and aggressive tax planning exert continuous downward pressure on corporate income tax rates. Capital mobility enables business owners to shift their corporate income to jurisdictions with favorable corporate tax systems. Nations have adopted a variety of strategies to combat loss of tax revenue to lower tax jurisdictions. Many countries have reduced the corporate rate from individual rate levels to corporate rates that are half or less than half of maximum individual rates in order to remain competitive. Others have adopted systems of low rates for businesses that are most mobile while retaining higher rates for businesses requiring large infrastructure investments. Some countries even have reduced the corporate rate to zero and increased individual rates or shifted the tax burden to consumption taxes like the value added tax to offset lost corporate revenues.

**Toward Corporate-Shareholder Tax Integration.** Whether the theoretical underpinnings for two level taxes on corporate earnings are sound or not, two level tax structures have become obsolescent. Continuing to impose a high corporate rate may drive businesses to lower tax jurisdictions. Even if high rates do not motivate choice of business location on any significant scale, political rhetoric has done much to persuade the public that the corporate rate in some countries is too high -- out of line with competitive corporate rates. Political assertions may similarly persuade the public that double taxation of corporate earnings is unjust, impractical, and uncompetitive even if untrue. Substitution of a single level income tax on corporate earnings may become necessary to protect the corporate income tax as a revenue source and may be more efficient in the current political climate than a two level tax.

Proposals to integrate corporate and shareholder taxes have taken four forms: i) corporate deduction for dividends paid to make the selection of debt or equity capital tax neutral; ii) imputation systems providing a shareholder credit for the corporate tax (advance corporate tax); iii) reduced or zero tax rate on shareholders’ receipt of dividends through an exclusion of the amount of dividends the taxpayer receives or a deduction for all or part of those dividend amounts; or iv) tax transparency of the entity. Each integration method is imperfect. Below this report will argue that the full transparency model with collection of tax at entity level to be most efficient.
i) Deductibility of dividends establishes neutrality between debt capital and equity capital. The current distinction between deductible interest and non-deductible dividends long has generated a bias toward debt financing. There are, however, real risk differences and burdens that distinguish debt from equity. Entities must meet their debt obligations, so that the obligation to pay interest burdens the entity and limits the entity’s free use of its debt capital. Debt also enjoys a general priority over equity capital on termination of the entity’s life, but debt generally does not participate in the entity’s growth. Those distinctions between debt and equity reflect themselves in accounting rules and entity valuation. While debt and equity have differing positions on an ownership continuum so that as one changes the characteristics of the specific debt issue, it comes to resemble equity ever more and vice versa. Yet, historical tax differences between debt and equity may prove difficult to overcome.

Probably more important is current double tax treaty practice, which tends to shift the location of income from the producing country to the investing country. The common practice of reducing the withholding rate on cross-border payments of interest and dividends often results in deductible payments reducing the tax in the jurisdiction of the entity’s operation and shifting the inclusion to the country where the capital provider is located. Sometimes that dividend and interest income does not incur a tax there either. Deductibility of dividends also would exacerbate the existing problem of deductible payments to tax exempt organizations which currently allow much corporate operating income to escape tax through the deduction.

ii) The imputation system for integration was popular in Europe until the ECJ held that the shareholder’s residence jurisdiction had to grant a credit for taxes paid by a foreign corporation that distributed a dividend to a resident shareholder even though the resident jurisdiction received no part of the corporate tax paid. Because imputation systems used a credit for corporate taxes paid, those systems avoided the problem of tax exempt shareholders which had no tax against which to claim the credit.

iii) Few jurisdictions continue to impose both corporate and shareholder level taxes without rate concessions relative to other sources of income. Many jurisdictions impose a lower rate on corporate dividends and gain from the sale of corporate shares than on other types of income, so that there is partial integration in the form of a full corporate level tax followed by a reduced shareholder level tax. Other jurisdictions have reduced both the corporate level tax and the shareholder level tax to balance the sum of the two to be more or less the same together as one full single level tax.

Assume that jurisdiction X considers fifty percent to be the ideal tax rate for all income. It could impose a fifty percent tax on entity level income for all entities and allow those entities

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to distribute their profits freely and without further tax to their owners. This is a simple solution. The entity bears the tax burden, pays the tax when it earns the income and where it earns the income. The recommendation I make in this report adopts a variant on this structure.

The combined forces of international tax competition and capital mobility, however, make it necessary to reduce the entity level tax in order to prevent capital flight to lower tax jurisdictions. Assume that international competitive norm limits the entity rate to twenty-five percent. The owner level tax must increase to 33.3 percent in order to capture the aggregate ideal fifty percent tax. While the possibility of reaching the ideal tax inheres, the outcome is less desirable and certain. The method defers the owner level tax until the entity distributes its income. Part of the tax may elude jurisdiction X if some of its owners are not subject to tax in the jurisdiction because they are exempt from tax or non-resident. For non-residents, a 33.3 percent withholding tax on entity distributions might gain the tax revenue but current treaty practice precludes such a high withholding tax on distributions.

iv) Tax transparency offers the most efficient and palatable solution to the one level tax rate conundrum by locating and taxing income where the taxpayer produces it without violating treaty obligations. See the Recommendation section below for discussion of this proposal.

**Recommendation.** Tax transparency forestalls tax competition by setting the nominal CIT rate at zero as imputation systems did. The corporation acts in a manner analogous to a withholding agent for its owners by paying the maximum shareholder tax on the entity’s income when and where the entity earns the income. Without regard to their countries of residence, shareholders would include in their individual incomes their shares of the entity’s income as if they received it directly from the source, in the manner, and at the time the corporation received the income.

Under a full transparency system, each underlying shareholder (through layers of corporations, if necessary) would be engaged in the corporation’s business in the taxing jurisdiction but only to the extent of the shareholder’s portion of the corporation’s income. Unlike imputation systems, the shareholder would not receive a dividend from the corporation the tax on which the shareholder could offset with the corporate tax paid. The shareholder would be primarily liable for the tax on corporate income and receive a credit for the entity level payment (or withholding) from the taxing jurisdiction against his or her individual income tax payable in that jurisdiction. Non-resident shareholders would not have to file an income tax return in the taxing jurisdiction but would receive no credit if they did not file. Shareholders could file a return of income in the taxing jurisdiction on their shares of the corporation’s income in that jurisdiction and receive a credit for the entity tax payment against the tax determined on that return. In order to assure collection of a tax on all operating income of the corporation, tax exempt shareholders would be taxable on their shares of the corporation’s operating income even if the shareholders are exempt on income from other sources.

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8 That is 25% of income, plus 1/3 of the remaining 75% of the entity’s income.
This transparency system should not run afoul of the imputation decisions of the ECJ\(^9\) because it treats all shareholders, without regard to residence, equally by imputing the entity’s business and location to all owners. Losses may prove more of a challenge. If the entity incurs a loss, the system would have to limit the deductibility of the loss for both resident and non-resident owners to income from that entity’s business, a carryover system, in order to remain permissible under ECJ decisions. While that limitation might prove unacceptable to some resident owners, the alternative of an entity level election to be taxable at the same rate as individuals would limit deductibility of the losses to the entity’s income. It is not likely to be a more suitable alternative since it would provide no shareholder level credit for the entity level tax even when the entity makes distributions.

Under this transparency recommendation, liquidity is not a problem as it is for many minority owners of existing transparent entities. In existing transparent entities, minority owners sometimes must depend on the good will of the controlling owners to distribute enough cash to enable the minority owners to pay tax on their shares of the entities’ incomes. Under this recommendation the entity pays the tax for its owners who may or may not claim the credit. Troubling for some taxpayers, however, may be the disclosure of beneficial ownership necessary to tax the underlying owners on their shares of the corporation’s income – a secrecy concern. Compulsory disclosure of beneficial ownership is a growing international trend, as jurisdictions seek to prevent their taxpayers from hiding investments. Nevertheless, owners concerned about ownership secrecy could choose not to include the income from the corporation and, in the case of a corporation in another jurisdiction, not file a return in that jurisdiction. Since the corporation has “withheld” at the highest individual rate, the jurisdiction in which the corporation earns its income loses no tax revenue.\(^{10}\)

In the presence of widely dispersed ownership interests, active trading of interests, and frequent presence of indirect ownership, transparency becomes complicated. Allocating entity income among an ever changing pool of shareholders requires adoption of various income accrual conventions such as allocation of all annual income evenly on an hourly or daily ownership basis. Computer technology should be equal to this challenge of computational complexity of a transparent entity. Technology already manages allocations in the gargantuan mutual fund industry.

**Continuing Capital Flight.** Full transparency does not eliminate the problem of capital flight. The CCCTB proposal\(^{11}\) may diminish the capital competition problem within the European Union insofar as shifting the place of the corporation’s management will not necessarily shift its income. But the CCCTB proposal may be only a first step in development of a worldwide

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9 See note 7 above and accompanying text.
10 Ultimately, secrecy of beneficial ownership is likely to yield to the needs of administering a global income tax. See note 5 above.
11 See note 2 above.
system to apportion business income (or all income) and permit jurisdictions to set rates rationally without concern of capital flight.¹²

¹² See note 5 above.