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*Guest Editor: Tim Edgar, Thaddeus Hwong & Jinyan  
Li*

Article 7

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## What Kind of Corporation Tax Regime? Sijbren Cnossen

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## What Kind of Corporation Tax Regime?

SIJBREN CNOSEN\*

This article explores the taxation of corporations in the wider context of capital income taxation. The article discusses pros and cons of various income-based and cash-flow forms of corporation tax (CT) and concludes that the dual income tax (DIT), which taxes all capital income at the proportional CT rate, is to be preferred over other forms of taxing capital income. The DIT is best attuned to the reality of capital mobility and is not held hostage by the higher tax on labour income. Levied at a uniform flat rate, the DIT minimizes opportunities for tax arbitrage.

Cet article étudie la taxation des sociétés dans le contexte plus étendu de l'impôt sur le revenu du capital. L'article discute du pour et du contre des diverses formes de l'impôt des sociétés, qu'il soit fondé sur le bénéfice ou sur les flux de trésorerie, et conclut que l'impôt sur le revenu double (DIR), qui taxe les gains de capital au taux proportionnel de l'impôt des sociétés, est préférable aux autres modes d'imposition des gains de capital. Le DIR

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\* Professor of Economics, University of Pretoria; Academic Partner, CPB Netherlands Bureau for Economic Policy Analysis; and Professor Emeritus, Erasmus University Rotterdam and the University of Maastricht. I dedicate this article to Neil Brooks whose friendship I cherish. Each year Neil and I teach at the African Tax Institute of the University of Pretoria. Further, I have been on an International Monetary Fund mission with Neil to Bangladesh, a trip that I survived thanks to Neil's collegiality and great sense of humour during the little time that was reserved for a joint beer each day. Throughout the mission, Neil showed that tax systems should not only be studied and understood, but also experienced. He applied this attitude to Bangladesh's income taxes, while I reviewed the country's messy product tax system. With this article, I venture with some trepidation into Neil's territory, remembering that even if I stubbornly ignore a fatal flaw in my argument, Neil will be there to point out that "it's only a flesh wound!" I am grateful to Peter Birch Sørensen for his detailed comments on the draft of this article and to Tim Edgar for drawing my attention to various Canadian and American publications on corporate income taxation. An earlier version of this article was presented at Tax Policy for a Better Tomorrow: Intersectoral and Multidisciplinary Connections (Blake, Cassels & Graydon LLP, Toronto, 10-11 May 2013).

s'harmonise mieux à la réalité de la mobilité des capitaux et n'est pas tenue en otage par l'impôt plus élevé sur le revenu du travail. Prélevée à un taux uniforme, le DIR réduit les risques d'arbitrage fiscal.

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## I. WHY TAX CORPORATIONS?

THE TAXATION OF CORPORATIONS has long been one of the most controversial and inconclusive topics in the public finance literature. Various rationales have been advanced as to why it is desirable, necessary, and convenient to tax corporations, but none is particularly persuasive.<sup>1</sup> As a result, the traditional arguments for taxing corporations must be reviewed, particularly in light of the greater mobility of capital and the increased importance of multinational companies.

### A. TRADITIONAL ARGUMENTS

Until recently, the literature distinguished three major functions of the corporation tax (CT): as a method of taxing foreign investment, as a method of taxing capital gains, and as a non-distorting tax on rents or pure profits.<sup>2</sup>

First, the CT can function as a method of taxing foreign investment. One of the longest standing arguments in favour of the CT is that source countries should have the primary claim to tax foreign direct investment. This argument, known as the source entitlement principle,<sup>3</sup> can be justified on benefit-received grounds (*i.e.*, the CT is viewed as a user charge for government-provided services), or as a method of sharing in the location-specific rents (say, access to a harbour or to skilled workers) that accrue to foreign-owned corporations. The taxation of foreign direct shareholders is also defended on the basis of the argument that not taxing them would benefit the treasuries of foreign countries that do tax foreign income and provide a credit against tax, or a deduction from income, for the source-country tax.

The second rationale for the CT is that it serves as a proxy for the tax that should be levied on capital gains that accrue to shareholders due to the retention of corporate profits. Through the CT, these gains are taxed on a current rather than a realization basis (the latter basis would produce deferral and lock-in effects). More generally, CTs serve as a backstop to the personal income tax (PIT) (albeit an imperfect backstop, if the CT rate is lower than the marginal

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1. Richard M Bird, "Why Tax Corporations?" (2002) 56:5 BFIT 194. Bird notes that for many people the most persuasive argument for taxing corporations is that that is where the money is. This is also what Willie Sutton said when the judge asked him why he robbed banks.
  2. John G Head, "Company Tax Structure and Company Tax Incidence" (1997) 4:1 Int'l Tax & Pub Fin 61 at 63; Ruud A De Mooij, "Will Corporate Income Taxation Survive?" (2005) 153:3 De Economist 277.
  3. Peggy B Musgrave, "Interjurisdictional coordination of taxes on capital income" in Sijbren Cnossen, ed, *Tax Coordination in the European Community* (Norwell, Mass: Kluwer Law and Taxation, 1987) 197 at 198.

PIT rate). Without the CT, corporations might be used to shelter other income, including labour income, from higher PIT rates. Beyond that, corporations act as third-party collectors for taxes on wages, interest, and dividends, and as suppliers of information on tax matters. In this context, the addition of the CT should not be particularly burdensome.

Third, the CT functions as a non-distortionary tax on pure profits (*i.e.*, the return in excess of the normal return).<sup>4</sup> The part of the CT that falls on pure profits is non-distortionary, regardless of whether the profit is distributed or retained by the company. In addition, it has been argued that a tax on distributed profits (normal as well as above-normal) earned by mature companies that can meet their need for equity through retentions does not distort investment.<sup>5</sup>

Although these arguments are largely compatible, they bypass an assessment of the incidence of the CT. In the tax literature, it is argued that in a small open economy, with perfect capital mobility, a source-based tax on the normal return will be fully shifted to local factors, such as relatively immobile labour, consumers, and land.<sup>6</sup> A source-based tax on mobile rents is also likely to be shifted to a large extent, whereas the burden of a tax on location-specific and hence immobile rents will be fully borne by capital owners. But the literature generally concludes that countries should continue to impose the CT in one form or another, so long as a more precise assessment of its incidence remains elusive.

## B. A BROADER VIEW OF THE ISSUES

The three functions of the CT have not been universally accepted. The source entitlement principle has been called into question because it is difficult to view the CT as a proxy for the benefits received from government-provided services. Targeted and specifically designed user charges would be more appropriate instruments. Further, it has been argued that all corporate source income,

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4. The normal return on capital is also called the hurdle or marginal rate of return, since it is the return at which an investment is just worth undertaking. The normal return is likened to the world rate of interest, adjusted for inflation and risk. In other words, it is the market return received by investors before PIT. By contrast, the above-normal return is defined as the rent that businesses earn; it is called the inframarginal return on investment.
  5. This is called the “new” view of dividend taxation, which, in contrast to the “old” view, holds that a tax on distributed profits reduces the company’s payout ratio and thus increases its cost of finance. For more on the new vs old view of dividend taxation, see the literature cited in Part II-B, below.
  6. GR Zodrow, “International Taxation and Company Tax Policy in Small Open Economies” in Iris Claus et al, eds, *Tax Reform in Open Economies* (London, UK: Edward Elgar, 2010). Specifically, Zodrow’s research suggests that the corporate tax burden is primarily borne by labour, particularly over time.

whether paid in respect of equity or debt, should be taken into consideration, particularly since the two sources of finance are largely substitutable. One can ask, along similar lines, if equity income is taxed on a source basis, why should interest be taxed on a residence basis, or vice versa? Another point is that the taxation of firm-specific rents affects the location decisions of multinational firms. Accordingly, a broader view of the functions of the CT is called for.<sup>7</sup> The more pertinent questions are how the corporate tax base should be defined, where that base should be taxed, and what the relationship should be between the CT and the (residual) PIT imposed on shareholders.

#### 1. WHAT IS THE BASE OF THE CT?

Conventionally, the base of the CT is defined as the profits of the corporation, determined on the basis of sound accounting principles. For instance, under the matching rule, the related costs and gains of doing business are considered on a period-by-period basis. Interest is deductible when computing taxable profits, depreciation charges reflect the costs of using capital equipment, and capital gains are accounted for on a realization basis. This accounting approach differs from the concept of true economic profits, under which profits are computed on an accrual basis as the difference between opening and closing wealth (both measured on a current value basis), adjusted for profit distributions and capital contributions. The measurement of true profits is, however, very demanding. In practice, it would require that all assets be re-valued each year to measure the real loss or gain. In the presence of inflation, moreover, adjustments would have to be made to the real value of the outstanding debt.<sup>8</sup>

Whether an accounting profits or a true profits approach is taken, the normal and above-normal returns on equity are taxed (the normal return to debt-financed investment is not subject to CT, due to interest deductibility). The normal return to equity is not taxed under a CT that takes as its base the cash flow of a business, defined as the amount that remains after capital equipment has been fully expensed (*i.e.*, written down immediately) and the deduction for interest has been clawed back. Under a source-based cash-flow tax, this base is equivalent to the base of an origin-based value-added tax (VAT) after deducting

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7. Alan J Auerbach, Michael P Devereux & Helen Simpson, "Taxing Corporate Income" in Stuart Adam et al, eds, *Dimensions of Tax Design: The Mirrlees Review* (London: Oxford University Press, 2010) 837 [Adam et al, eds, *Dimensions of Tax Design*].

8. For a useful treatment, see Robin W Boadway, Neil Bruce & Jack M Mintz, "Corporate Taxation in Canada: Toward an Efficient System" in Wayne R Thirsk & John Whalley, eds, *Tax Policy Options in the 1980s* (Toronto: Canadian Tax Foundation, 1982) 171.

wages from the difference between sales and purchases. On the other hand, if the cash-flow tax is destination based, its base is roughly equivalent to that of the usual destination-based VAT, minus wages. Under a variant of the business cash-flow CT, but with equivalent result, capital investments would be depreciated in a conventional manner, but, additionally, a presumptive interest charge on the undepreciated basis would be deductible from profits.

## 2. WHERE SHOULD THE CT BASE BE TAXED?

Conventionally, profits are taxed on a source basis, although residual corporate income (*i.e.*, dividends and capital gains) is taxed on a residence basis. Also, in principle, interest is taxed in the country of residence. Source-country taxation would be achieved more fully by prohibiting a deduction for interest from taxable profits. Residence-country taxation would be achieved more fully by permitting a deduction for dividends at the corporate level in the source country and allowing a credit for the foreign CT against the tax on capital gains accruing to shareholders in the residence country.

Source-country taxation goes by the name of separate accounting or separate entity taxation, because corporations are required to determine their worldwide profits on a country-by-country basis, under what is called the arm's length principle. Just like the determination of true economic depreciation and the accrual taxation of capital gains, administratively, arm's length taxation is an extremely demanding design requirement. Equally demanding is the determination of the appropriate debt-equity mix, if interest is deductible and dividends are not. These problems tend to be less severe if two or more countries agree to determine the taxable profits of corporations operating in both countries in accordance with formulary apportionment. Under this approach, the countries would apply the respective CTs to a common base that is apportioned on the basis of an agreed formula (generally comprising sales, payroll, and capital). Essentially, this turns the CT into a tax on the factors in the formula with different effects at the margin than a traditional profits tax.

## 3. WHAT IS THE RELATIONSHIP BETWEEN THE CT AND THE PIT?

Questions about the most appropriate CT base and its taxing locus also have implications for the taxation of capital income other than corporate profits. If corporate equity income (and, possibly, interest income) is taxed at the level of the corporation, should dividend income be exempted at the level of the recipient? Or, should there be a second layer of tax in the form of the PIT? Perhaps, the normal return on equity should not be taxed again, though rents

might be subject to the PIT as well as the CT. And what about other capital income, such as income from immovable property? Should it be taxed at the same rate as equity income? Further, under a business cash-flow tax, should the normal return on non-corporate investments also be exempted? In other words, should an expenditure tax be imposed next to a cash-flow CT? Moreover, the question of where personal capital income should be taxed is as relevant as it is for corporate equity income. Traditionally, interest income is taxed on a residence basis, although final withholding taxes<sup>9</sup> may be used to introduce a source-country element.

The nature of the PIT rate structure that is applied to capital income is important in the context of CT-PIT relationships. Traditionally, all capital income other than retained profits has been joined with labour income and subjected to the same (progressive) PIT rate structure. In recent years, however, capital mobility and tax arbitrage considerations have led to the separation of capital income from labour income. Thus, labour income can continue to be taxed at progressive rates, while capital income is taxed at a lower, proportional rate (*i.e.*, the CT rate).

### C. ORGANIZATION OF THE ARTICLE

This article focuses especially on CT-PIT relationships, known as CT regimes. A distinction is made between CTs that purport to tax the normal return to capital (income-based CTs) and CTs that confine the base to above-normal returns to capital (cash-flow-based CTs). Income-based CTs are subdivided into conventional CT regimes (discussed in Part II) and schedular income tax systems (discussed in Part III). Conventional CTs are a schedular element in otherwise comprehensively defined income tax systems, which tax all income from capital and labour jointly at the same (progressive) rate structure. On the other hand, under schedular (non-comprehensive) income tax systems, profits along with all other capital income are taxed separately from labour income at different, generally proportional rates. Cash-flow-based CTs that confine the base to inframarginal profits are examined in Part IV. Part V sums up the main considerations that factor into the choice of the most appropriate CT and concludes that the dual income tax (DIT), which has been pioneered in the Nordic countries, is the most appropriate CT.

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9. Withholding taxes on interest, dividends, or wages for that matter, are payments in advance of and creditable against the final CIT or PIT liability. The advance payments are collected by the payer (*i.e.*, the source of the remuneration). Withholding taxes are called final if subsequent creditability is not allowed.



## II. CONVENTIONAL CORPORATION TAX REGIMES

As a tax on the return on equity, the CT interacts with the PIT of shareholders entitled to corporate profits. In tax law and theory, this interaction may either be denied or be explicitly recognized and reflected in the form of the tax. Following a brief overview of conventional CT regimes, Part II discusses the classical system, full integration, dividend relief systems, and various ad hoc approaches to the double taxation of profits distributed by corporations.<sup>10</sup> Generally, the discussion abstracts from open economy considerations (*i.e.*, the influence of foreign investment).

### A. OVERVIEW

Figure 1 presents the various conventional CT regimes that can be distinguished based on whether and to what extent they are integrated with the PIT of shareholders. At one extreme, under the classical system, the corporation is regarded as an entity entirely separate from its shareholders and taxed as such.<sup>11</sup> At the other extreme, the corporation is viewed as a pass-through, a conduit of shareholders' corporate equity income, including distributed as well as undistributed earnings. The CT, if retained, functions solely as a prepayment of the PIT, just like a wage withholding scheme.

In practice, the integration of the CT with the PIT of shareholders is limited to distributed profits, called dividends. This form of partial integration, often referred to as dividend relief, can be achieved either at the shareholder level or at the corporate level. At the shareholder level, dividend relief can be provided systematically (*i.e.*, proportionate to the marginal PIT rates of shareholders) under the imputation system, which permits shareholders a full or partial credit against their PIT for the CT that can be imputed to the dividends, grossed-up by the tax

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10. Sijbren Cnossen, "Role of the Corporation Tax in OECD Member Countries: A Survey and Evaluation" in John G Head & Richard Krever, eds, *Company Tax Systems, Conference Series No. 18* (Sydney: Australian Tax Research Foundation, 1997) 49.

11. The label "classical system" was introduced by AJ van den Tempel. See AJ van den Tempel, *Corporation Tax and Individual Income Tax in the European Communities* (Brussels: Commission of the European Communities, 1970) at 7. It should be noted, however, that contrary to what the terminology suggests, the imputation system, discussed below, is dated. By the nineteenth century, some German states already had some form of imputation. In 1922, imputation was incorporated as the withholding method in the Model Income Tax Ordinance of the United Kingdom, which was introduced in many colonies. Richard Goode discusses the classic treatment of the separate entity system. See Richard Goode, *The Corporation Income Tax* (New York: John Wiley & Sons, 1951) at 16-17.

credit, and received by them. Alternatively, dividend relief can be provided in an ad hoc manner at the shareholder level, by taxing dividend income at a flat rate (lower than the highest marginal PIT rate) or by exempting all or part of the net dividend received by shareholders. The most obvious method of dividend relief at the corporate level is to permit a deduction for dividends from taxable profits, as is commonly done for interest. This is called the dividend-deduction system. Another approach that can achieve the same result is the split-rate system, under which a lower tax rate is levied on distributed profits.

**FIGURE 1: RELATIONSHIP BETWEEN CORPORATION TAX (CT) AND PERSONAL INCOME TAX (PIT)**

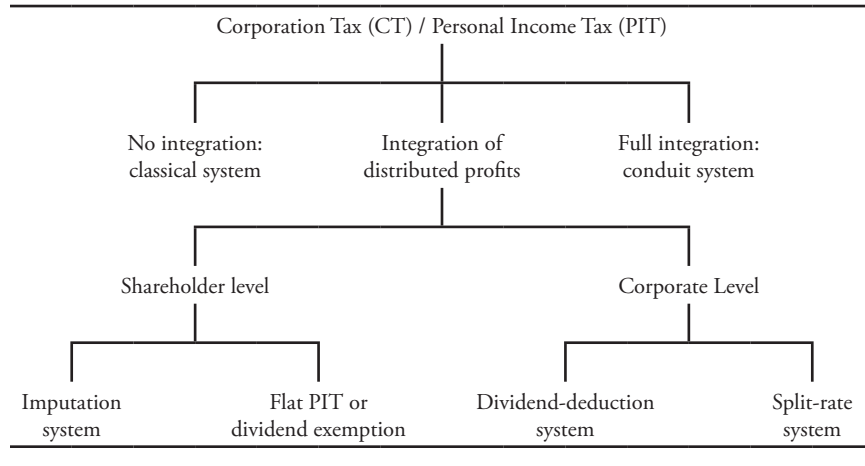


Table 1 illustrates the various forms of CT-PIT relationships numerically for a corporation with profits of \$300 before the CT. The profits after the CT are assumed to be fully distributed and taxed again at the shareholder level, at PIT rates of 30% or 50% with or without relief (fully or partially) for the CT imputable to the dividend. Subsequently, the total CT + PIT burden is calculated and expressed as a percentage of the profits before the CT. The resulting effective tax rate is then compared with the two nominal PIT rates and the degree of over-taxation expressed as a percentage of these PIT rates. Finally, the degree of tax relief (the reduction of the CT + PIT burden as a percentage of the over-taxation under the classical system) is calculated for each approach.

TABLE 1: FORMS OF CORPORATION TAX (IN CAD UNLESS OTHERWISE INDICATED)

Form of CT	Classical system	Full integration	Imputation	Dividend relief systems	Split CT rate	Lower, flat PIT rate	Schedular approaches
Degree of CT-PIT integration (CT = 20%)	None	Full	1/8 of net dividend	50% of profits before tax	10% CT on distributions	43.75% PIT on dividend	1/8 of net dividend
<b>A. Corporate level</b>							
1. Profits before CT	300	300	300	300	300	300	300
2. Dividend-deduction				150			
3. Net profits				150			
4. CT	60	60	60	30	30	60	60
<b>B. Shareholder level</b>							
5. PIT rate	30%	50%	30%	50%	30%	50%	30%
6. Net-of-CT dividend	240	240	240	270	270	240	240
7. Imputed CT		60	30	30			
8. Grossed-up dividend		300	270	270			

TABLE 1: FORMS OF CORPORATION TAX (IN CAD UNLESS OTHERWISE INDICATED)

Form of CT	Classical system	Full integration	Imputation	Dividend relief systems		Schedular approaches							
				Dividend deduction	Split CT rate	Lower, flat PIT rate	Dividend exemption						
9. PIT	72	120	90	150	81	135	81	135	105	105	63	105	
10. Credit for imputed CT		60	60	30	30								
11. Net PIT		30	90	51	105								
<b>C. Combined tax burden</b>													
12. Total tax	132	180	90	150	111	165	111	165	111	165	165	123	165
13. Effective tax rate	44%	60%	30%	50%	37%	55%	37%	55%	37%	55%	55%	41%	55%
14. Overtaxation	47%	20%	0%	0%	23%	10%	23%	10%	23%	10%	83%	10%	37%
15. Tax relief	0%	0%	100%	100%	50%	50%	50%	50%	50%	50%	-77%	50%	21%
<b>Glossary and definitions</b>													
CT = corporation tax; PIT = personal income tax													
Effective tax rate = total tax as percentage of profits before CT													
Overtaxation = (effective tax rate minus PIT rate) as percentage of PIT rate													
Tax relief = (classical overtaxation minus overtaxation under particular CT) as percentage of classical overtaxation													
NOTES: Author's calculations; figures may have been rounded. The degree of CT-PIT integration for the lower, flat PIT rate and the (partial) dividend exemption has been calculated on the assumption that the tax relief should be 50% for the 50%-bracket shareholder, equal to the relief under the dividend relief systems.													

## B. THE CLASSICAL SYSTEM

Under the classical or separate entity system of corporation tax, no deduction for dividends to shareholders is allowed when computing taxable profits. Moreover, dividends are taxed again in full in the hands of shareholders at rates that differ from one shareholder to another depending on the amount of the dividend and the shareholders' other income, but that may range from the lowest to the highest marginal rate of the progressive PIT. This phenomenon is called the "economic double taxation of dividends."<sup>12</sup>

The workings of the classical system are shown in column 2 of Table 1. The profits after the CT of \$240 are distributed in full and taxed again at the shareholder level at PIT rates of 30% and 50%, respectively, resulting in PIT liabilities of \$72 and \$120 and combined CT and PIT liabilities of \$132 and \$180. When expressed as a percentage of original corporate equity income, these liabilities translate into effective tax rates of 44% for the 30% bracket shareholder and 60% for the 50% bracket shareholder. When these effective rates, in turn, are compared to the appropriate marginal tax rate of each shareholder, the dividend income of the 30% shareholder is over-taxed by 47%, while that of the 50% shareholder is over-taxed by 20%.

However, this is not the only possible outcome. Corporate equity income, if retained, may also be under-taxed compared to the marginal PIT rate of the shareholder. In this case, the effective tax rate for both shareholders in Table 1 would be 20%. In other words, the 30% shareholder would be under-taxed by 33.33% while the 50% shareholder would be under-taxed by 60%. Furthermore, if half of the profits after the CT were distributed (perhaps a more realistic assumption than either no or full distribution), the 50% shareholder would be taxed at an effective rate of 40% (*i.e.*, under-taxed by 20%), while the 30% shareholder would still be over-taxed by 7%. In a broader—and more correct view, therefore—the real issue under conventional CT regimes is not that dividend income is taxed twice or that the separate CT exhibits a tax bias in favour of retained profits, but that corporate equity income, distributed as well as retained, is not taxed in accordance with the marginal PIT rates of shareholders.

Proponents of the classical system deny the relevance of the interaction between the CT and the PIT. They point out that in large public corporations, ownership and control functions have been completely divorced from one another, and that managers do not take PITs into account when making

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12. McLure discusses the classical treatment of the double-taxation issue. Charles E McLure Jr, *Must Corporate Income Be Taxed Twice?* (Washington: Brookings Institution, 1979).

investment decisions.<sup>13</sup> Opponents of the classical system, on the other hand, have argued—in my view rightly so—that both the CT and the PIT on equity income enter the wedge between the before-tax return of the corporation and the after-tax return (the reward for saving) that must be paid to shareholders to induce them to put up their capital.<sup>14</sup> This wedge (and, by extension, the required return) will vary depending on the choice of financing (*i.e.*, retained profits, new equity, or debt) and the corporation's dividend policy (distribution or retention).<sup>15</sup> Consequently, the double tax affects entrepreneurial behaviour and violates the principle that economic considerations rather than tax motives should determine the behaviour of entrepreneurs.<sup>16</sup>

The economic distortions of the classical system have not gone unchallenged in the finance and public finance literature.<sup>17</sup> In the finance literature, Franco Modigliani and Merton Miller argued that in the absence of tax and bankruptcy costs, the cost of capital will be independent of the pattern of finance.<sup>18</sup> Modigliani and Miller further argued that under a CT with interest deductibility, companies will prefer debt to equity provided the PIT rate on interest income is below the CT rate, and vice versa.<sup>19</sup> Joseph Stiglitz maintained the assumptions underlying Modigliani and Miller's studies and argued that, under the US tax rules prevailing at that time, debt was the preferred marginal source of corporate finance<sup>20</sup> so that the CT would not distort investment decisions due to the deductibility of interest.<sup>21</sup> Moreover, while the tax system does affect the pattern of finance in

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13. Goode, *supra* note 11.

14. Bird, *supra* note 1.

15. In addition, the size of the wedge will depend on the business form in which the investment is undertaken (the corporate or non-corporate form), the tax status of the recipient of the return (taxable or exempt), and the place of the shareholder's residence (within or outside the taxing jurisdiction).

16. The double taxation of dividends has been viewed as inequitable, especially regarding low-income shareholders. Conversely, it has induced wealthy shareholders to shield their capital income in the corporate form and to reap the return on equity in the form of exempt or lowly taxed capital gains.

17. Head, *supra* note 2 at 63.

18. "The Cost of Capital, Corporation Finance and the Theory of Investment" (1958) 48:3 Am Econ Rev 261.

19. "Corporate Income Taxes and the Cost of Capital: A Correction" (1963) 53:3 Am Econ Rev 433.

20. "Taxation, Corporate Financial Policy, and the Cost of Capital" (1973) 2:1 J Public Econ 1.

21. *Ibid.*

the model set up by Stiglitz, this does not generate any loss of efficiency due to Modigliani and Miller's assumptions.<sup>22</sup>

The second challenge comes from the public finance literature. Under the traditional or old view of dividend taxation, it is assumed that shareholders derive a positive benefit from receiving dividends. Dividends provide a signal to shareholders that all is well with the company. They may also limit financial discretion and hence potential misuse of funds by management. Under this view, the PIT reduces the dividend payout ratio when the effective PIT rate on dividend income exceeds the effective PIT rate on capital gains on shares. Since investors value dividends, this fall in the payout ratio increases the company's cost of finance. By contrast, under the new view, the double taxation of retained earnings (through the personal capital gains tax) distorts corporate investment, whereas a tax on the dividends paid out by mature companies does not.<sup>23</sup> Although the issue is far from resolved, most empirical studies tend to support the traditional view.<sup>24</sup> Whatever view is adopted, taxing dividends twice always harms investment by new businesses, which have to rely on new share issues to provide for their equity needs. On balance, the economic distortions of the classical system are real, although perhaps not as large as sometimes thought.

### C. FULL INTEGRATION

The economic distortions caused by the classical system should not occur in a transparent, competitive world in which the CT is fully integrated with the PIT of shareholders. Under full integration, the corporation would serve as a conduit. It would be a pass-through of corporate equity income, which would be taxed fully in the hands of the shareholders at the appropriate PIT rate. Column 3 of Table 1 illustrates the workings of full integration. For PIT purposes, it is

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22. As noted, these assumptions include the absence of bankruptcy and agency costs of monitoring the firm. It has been pointed out that debt brings non-tax costs and non-tax benefits. Gordon and Malkiel discuss how non-tax costs arise when debt increases the risk of bankruptcy. See Roger H Gordon & Burton G Malkiel "Corporation Finance" in Henry J Aaron & Joseph A Pechman, eds, *How Taxes Affect Economic Behaviour* (Washington: Brookings Institution, 1981) 131 at 132. See also Michael C Jensen & William H Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3:4 *J Fin Econ* 305 at 338. Jensen and Meckling discuss how non-tax benefits occur when interest payments reduce business cash-flow and thus improve managerial efficiency.
23. Hans-Werner Sinn discusses the debate between the traditional view and the new view. See Hans-Werner Sinn, "Taxation and the Cost of Capital: The 'Old' View, the 'New' View, and Another View" (1991) 5 *Tax Pol'y & Econ* 25.
24. George R Zodrow, "On the 'Traditional' and 'New' Views of Dividend Taxation" (1991) 44:4 *Nat'l Tax J* 497.

irrelevant whether or not a corporation distributes profits and, if so, to what extent. Retained as well as distributed profits are fully taxed according to what has been called the “partnership method,” whereby profits are allocated in proportion to each shareholder’s holding in the corporation’s equity.<sup>25</sup> The CT is simply a prepayment for the PIT. It follows that effective tax rates are equal to respective bracket rates; there is no over-taxation.

Full integration is one of the normative implications of the accretion concept of income, as formulated by Georg von Schanz, Robert M. Haig, and Henry C. Simons.<sup>26</sup> Advocates of the accretion concept point out that ability to pay, being an equity notion, can only be related to natural persons. It follows that if income is chosen as the best index of the ability to pay, the equal treatment rule requires that the definition of income be all inclusive. For tax purposes, there should be no difference between corporate profits and other capital income, such as interest and rental income, or between capital income and labour income, including wages and salaries, which is subject to the PIT. There is no place, therefore, for an extra tax on distributed profits, or for the preferential treatment of profits retained by the corporation and taxed below the marginal PIT rate of shareholders.

Full integration has been considered by the Royal Commission on Taxation in Canada (Carter Commission),<sup>27</sup> the US Department of the Treasury (Blueprints), and the Campbell Committee in Australia (Campbell Committee).<sup>28</sup> Under both the Carter Commission’s voluntary CT and PIT rate alignment plan<sup>29</sup> and the mandatory partnership method proposed under Blueprints and the Campbell Committee,<sup>30</sup> all corporate equity income would be allocated to shareholders

25. McLure, *supra* note 12.

26. The accretion concept of income is also known as the S-H-S income concept, after its creators Schanz, Haig, and Simons. Goode provides a classical exposition of the S-H-S income concept. See Richard Goode, *The Individual Income Tax*, revised ed (Washington: Brookings Institution, 1976). For the normative inference of full integration, see Richard A Musgrave & Peggy B Musgrave, *Public Finance in Theory and Practice*, 4th ed (New York: McGraw-Hill, 1984) at 386.

27. Canada, *Report of the Royal Commission on Taxation*, vol 4 (Ottawa: Queen’s Printer, 1967) [Carter Commission]. Collins and Edgar discuss the Carter Report’s proposals as well as the aftermath. See Kirk A Collins & Tim Edgar, “The Carter Report’s Corporate Income Tax Proposals: Why They Were Rejected and an Assessment of the Current Canadian System as in Imperfect Alternative” in Kim Brooks, ed, *The Quest for Tax Reform Continues: The Royal Commission on Taxation Fifty Years Later* (Toronto: Carswell, 2013) 115.

28. US, Department of the Treasury, *Blueprints for Basic Tax Reform* (Washington: Department of the Treasury, 1977) at 5 [Blueprints]; Austl, Commonwealth, Australian Financial System Inquiry, *Australian Financial System: Final Report of the Committee of Inquiry* (Canberra: Australian Government Publishing Service, 1981) [Campbell Committee].

29. Carter Commission, *supra* note 27.

30. Blueprints, *supra* note 28 at 135; Campbell Committee, *supra* note 28.



and taxed in their hands, with a full credit for the CT paid on their behalf by the corporation. To prevent double taxation of retentions, the basis for corporate shares would be written up by the amount of the allocation, net of the CT. Profit distributions would be considered repayment of capital, up to the amount of the written-up basis; further repayments would be treated as taxable capital gains.

These plans, however ingenious, have never left the drawing board, primarily because they are considered impractical.<sup>31</sup> In particular, critics have pointed out that delays in completing CT assessments would have repercussions on the filing of shareholders' PIT returns; that it would be difficult to deal with different types of equity; that an undesirable side effect might be that preferential income items would be passed through to shareholders; and last but not least, that shareholders might have to pay additional PIT, although no cash had in fact been received.

Further complications arise when cross-border investments are taken into consideration. Under global, fully integrated CTs the returns on these investments should be taxed currently on the basis of the residence principle, in violation of the source entitlement principle, while a credit for the source country's CT would effectively hold the residence country hostage to the source country's tax policy. Moreover, residence countries typically cannot enforce compliance in filing the correct return of foreign equity income—especially if profits are retained in the source country and that country does not cooperate.

In the domestic context, New Zealand's full imputation system used to approximate full integration by setting the top PIT rate of 33% at the same level as the proportional CT rate. As a result, the effective tax rate for top-bracket taxpayers was the same regardless of whether corporate source income accrued in the form of retained profits, dividends, or interest. Charles McLure has called this approach "integration by the backdoor," because shareholders in low-income brackets will push for profit distribution, while high-income shareholders do not benefit from profit retention.<sup>32</sup> Currently, however, the CT rate is 28% while the top PIT rate still stands at 33%.<sup>33</sup> As a result, the backdoor has been closed.

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31. *Supra* note 12 at 17; US, *Report of The Department of the Treasury on Integration of The Individual and Corporate Tax Systems: Taxing Business Income Once* (Washington: Department of the Treasury, 1992) at 81 [*Taxing Business Income*].

32. *Supra* note 12.

33. These rates exclude the 1.45% contribution of corporate profits to fund the Accident Compensation Corporation. The Accident Compensation Corporation is a New Zealand Crown entity responsible for administering the country's universal no-fault accidental injury scheme. The scheme provides financial compensation and support to citizens, residents, and temporary visitors who have suffered personal injuries.

#### D. DIVIDEND RELIEF SYSTEMS

Full integration has been characterized as the search for a perfect solution in an imperfect world. Yet, at the same time, it has been considered important to eliminate or mitigate the economic distortions of the so-called classical system, under which corporate distributions are taxed at the corporate level and again at the shareholder level. As a halfway house to the ideal, various dividend relief systems exist under which distributed profits, at least, are taxed in accordance with the shareholder's marginal income tax rate.

##### 1. IMPUTATION SYSTEM

The workings of the imputation system are shown in column 4 of Table 1. It is assumed that the intention is to provide dividend relief for all shareholders at a rate of 50%, measured against the over-taxation that exists under the classical system. This is achieved by requiring the shareholder to gross-up his or her net dividend of \$240 by one-eighth, representing half of the CT attributable thereto. The grossed-up dividend of \$270 is then added to his or her other income and subjected to the progressive PIT. Next, the gross tax, \$81 or \$135, respectively, is credited with the CT with which the net dividend was grossed up in the first place. The balance represents the net tax payable or refundable. Imputation, therefore, has the same gross-up and tax credit features as a dividend withholding tax. Moreover, the withholding technique works as an anti-evasion device because nationals holding stock through nominee accounts do not benefit from the relief.

The tax credit under an imputation system can be expressed as a fraction of the net dividend, indicating the usual legal form of dividend relief, or as a percentage of the CT, showing the extent to which the double tax is mitigated (see column 4 of Table 1). The tax credit can also be calculated as a percentage of the grossed-up dividend, representing the comparable tax-inclusive PIT rate. If the latter percentage equals the basic PIT rate, and the shareholder's other income is also subject to the basic PIT rate, a tax assessment is not required. In Table 1, column 4, the imputation credit of one-eighth of the net dividend equals one-half of the CT, which equals one-ninth of the grossed-up dividend.

Imputation systems are complicated by the need for a compensatory tax at the corporate level on profits distributed out of exempt earnings that have not been subject to the national CT. In turn, the compensatory tax requires rules for the sequence in which profits are presumed to be distributed. Such distribution is generally presumed to be on a highest-in-first-out basis. Although imputation systems are meant to promote profit distributions, the compensatory tax creates an incentive to retain exempt profits in the corporation in order to minimize the

CT liability. Further, rules have to be promulgated for the treatment of inter-company dividends, foreign shareholders and foreign direct investment, and refunds for exempt entities.<sup>34</sup>

## 2. DIVIDEND-DEDUCTION SYSTEM

The dividend-deduction system is the most obvious approach to the double taxation issue. It permits dividends as a deduction from taxable profits, as is the case with interest. The workings of the dividend-deduction system are shown in column 5 of Table 1. To achieve 50% relief, the same as under the imputation system, one-half of profits marked for distribution should be made deductible in determining taxable profits. It is possible, of course, to vary the degree of dividend relief. A full deduction makes the system equivalent to an undistributed profits tax, with which the United States briefly, and not altogether favourably, experimented in the 1930s. A small deduction moves the system closer to the classical CT.

Unless the goal is to stimulate equity investment by non-residents, one drawback of the dividend-deduction system is that the relief is automatically extended to foreign shareholders and exempt entities, which do not pay the additional, national PIT incurred by domestic shareholders.<sup>35</sup> To prevent this, a dividend withholding tax could be introduced or increased to make the dividend-deduction system equivalent to an imputation system. Without a withholding complement, the dividend-deduction system would jeopardize the effective one-level taxation of distributed profits. A final objection to the

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34. For a more detailed review of these schemes, see Cnossen, *supra* note 10. Imputation systems used to dominate the CT picture in the European Union, especially in the 1970s and 1980s. Over time, however, they were regarded as overly complicated, while their cross-border implications were held to be discriminatory. See ECJ, *Petri Manninen*, C-319/02, [2004] ECR I-07477, 3 CMLR 40 [*Manninen*]. In *Manninen*, the European Court of Justice held that the Finnish imputation system violated the free movement of capital principle laid down in art 56 of the EC Treaty. The imputation tax credit was not available to dividends received from foreign corporations. Hence, the court argued, this deterred taxable persons in Finland from investing in other member states. Finland could remedy the situation by also allowing the credit for foreign dividends, but then it would be giving relief without having collected any tax in the first place.

35. The US Department of the Treasury included a proposal for a 50% deduction, later reduced to 10%, for dividends paid. Interestingly, the automatic extension of the benefit to non-residents was seen to be positive because the resulting increase in the incentive for inward foreign investment would help finance the current US account deficit. See US, *Tax Reform For Fairness, Simplicity, and Growth: The Treasury Department Report to the President*, vol 3 (Washington: Office of the Secretary, Department of the Treasury, 1984).

dividend-deduction system is that the CT cannot serve as a means of verifying the correct return of dividend income for the PIT.<sup>36</sup>

### 3. SPLIT-RATE SYSTEM

Under the split-rate system, distributed profits are taxed at a lower rate than retained profits. Table 1, column 6, provides an illustration of the split-rate system that taxes distributed profits at a lower rate of 10% and retained profits at 20%. Similar to both the imputation system and the dividend-deduction system, the dividend relief is 50% compared to the degree of over-taxation under the classical system. Of course, if the rate differential is small, the split-rate system resembles the classical CT, and if the differential is large, it again becomes an undistributed profits tax.

One disadvantage of the split-rate system, absent a withholding tax complement, is that foreign parent companies with domestic subsidiaries can avoid the higher rate on retained profits by first distributing the subsidiary's earnings and then channelling them back as equity for reinvestment purposes.

### 4. EQUIVALENCY OF DIVIDEND RELIEF SYSTEMS

As shown in Table 1, columns 4–6, all three forms of dividend relief can provide the same degree of tax relief, expressed as a percentage of the classical system's degree of over-taxation. In other words, the effective tax rate on distributed corporate profits is the same. In general, this finding holds if:

1. the CT rate on undistributed profits under the split-rate system is the same as the uniform CT rate under the dividend-deduction system and the imputation system;
2. the net dividend under the split-rate system and the dividend-deduction system is the same as the grossed-up dividend under the imputation system; and

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36. Interestingly, in the 1980s, a deduction for dividends paid on new share issues received strong support from proponents of the new view, particularly in the United States. For instance, the American Law Institute proposed a limited deduction, determined by applying a risk-free rate of interest for dividends on new equity, as well as a corporate excise tax on redemptions. See US, American Law Institute, "Tentative Draft No. 2: Subchapter C" in *Federal Income Tax Project* (Philadelphia: American Law Institute, 1979). Warren, however, argued that the proposal would not be feasible and concluded that integration is "preferable in theory and workable in practice." See Alvin Warren, "The Relation and Integration of Individual and Corporate Income Taxes" (1981) 94 Harv L Rev 717 at 719. See also Alvin C Warren, "Integration of the Individual and Corporate Income Taxes: Reporter's Memorandum No. 3" in *Federal Income Tax Project* (Philadelphia: American Law Institute, 1993).

3. the CT rate on distributed profits under the split-rate system is equal to  $t(1-q)$  under the dividend-deduction system and also equal to  $t(1+r)-r$  under the imputation system, in which  $t$  is the uniform CT rate under the dividend-deduction system and the imputation system,  $q$  is the dividend-deduction as a proportion of the profits before CT and the dividend-deduction under the dividend-deduction system, and  $r$  is the tax credit as a proportion of the net dividend under the imputation system.<sup>37</sup>

The most important assumption underlying this result is that dividend payout rates are not affected by the choice of dividend relief system. This will be the case if corporate managers attach equal weight to taxes at both the corporate and shareholder level. However, if corporate managers consider the tax savings at the corporate level more important, then the payout rate under the split-rate system and the dividend-deduction system may be higher than under the imputation system. Further, it is assumed that under all dividend relief systems, shareholders are subject to the same average marginal PIT rates weighted in proportion to the total outstanding shares held by each shareholder.

#### E. AD HOC APPROACHES

Under less structured forms of dividend relief, net dividend income is taxed in the hands of shareholders at a flat PIT rate that is lower than the top marginal PIT rates. Table 1, column 7, shows the arithmetic of a separate, low flat PIT rate of 43.75%. Clearly, one objection to this form of dividend relief is that the benefit is distributed regressively with respect to income. Dividend relief from the classical over-taxation of 50% for the 50% bracket shareholder corresponds to a negative relief of -77%—in other words, an additional tax of 25% for the 30% bracket shareholder, as compared to the classical system. Essentially, the goal of dividend relief, which is the prevention of double taxation, conflicts with the objective of progressivity. Progressivity refers to tax that rises proportionately faster than income rises. This conflict can be mitigated, but not eliminated, by permitting an exemption equal to one-eighth of the net dividend, as illustrated in column 8 of Table 1. Again, this provides 50% relief to the 50% shareholder, but the 30% shareholder is still overtaxed by 37%. In spite of these objections, ad hoc approaches are widely found in OECD member countries.

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37. For the mathematical proof of the equivalency, see Sijbren Cnossen, "Alternative Forms of Corporation Tax" (1984) 1:3 *Austl Tax F* 253.

### III. SCHEDULAR INCOME TAX SYSTEMS

In a small open economy with perfect capital mobility, any source-based tax on the normal return to capital will be fully shifted onto domestic, immobile factors of production through an increase in the pre-tax rate of return required by investors. In this situation, it is simply not optimal for a small economy to levy any source-based tax on the normal return. In practice, however, corporate capital is not perfectly mobile. That said, the degree of international mobility is high, and this is a key argument for keeping any source-based tax low, absent international tax coordination. Furthermore, capital market innovation in conjunction with tax arbitrage implies that it is not feasible to tax capital income effectively at high progressive rates. If, for revenue and distributional reasons, the top PIT rate cannot be lowered to the level of the lower CT rate, the obvious solution is to tax capital income on a schedular basis. Basically, two variants have been developed that embody this philosophy: the dual income tax (DIT) and the comprehensive business income tax (CBIT).

#### A. DUAL INCOME TAX (DIT)

A pure DIT has nine main features.<sup>38</sup>

##### 1. INCOME SPLIT

All income is systematically separated into either capital income or labour income. Capital income includes interest, dividends, capital gains, imputed returns on capital invested in non-corporate businesses, rents, and rental values. Labour income consists of wages and salaries (including the value of the labour services performed by the owner in his or her business), fringe benefits, pension income, and social security benefits. Royalties are taxed as capital income if know-how is acquired or capitalized, otherwise as labour income.

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38. This section draws on reviews and evaluations of the economic and technical aspects of the DIT conducted by Cnossen and Sørensen. See Sijbren Cnossen, "Taxing Capital Income in the Nordic Countries: A Model for the European Union?" in Sijbren Cnossen, ed, *Taxing Capital Income in the European Union: Issues and Options for Reform* (Oxford: Oxford University Press, 2000) 180 [Cnossen, *Taxing Capital*]; Peter Sørensen, "Dual Income Taxes: a Nordic System" in Iris Claus et al, eds, *Tax Reform in Open Economies* (London: Edward Elgar, 2010) 78 [Sørensen, "Dual Income Taxes"]. The DIT was pioneered in Denmark in 1987, but the country subsequently strayed from the DIT path by moving back to a comprehensive income tax. Sørensen provides an earlier analysis. See Peter Sørensen, ed, *Tax Policy in the Nordic Countries* (London: Macmillan Press, 1998) [Sørensen, *Tax Policy*].

## 2. TAX RATES

Capital income, individual as well as corporate, is taxed at the proportional CT rate, while labour income is subject to additional, progressive PIT rates. To minimize tax arbitrage, the tax rate on labour income applicable to the first income bracket is set at the same level as the proportional CT rate.

## 3. COSTS OF EARNING INCOME

Costs incurred to earn income are deductible only against income subject to the capital income tax rate, which is the same as the lowest rate on labour income. This implies that mixed expenses, which contain an element of personal consumption, have the same tax value for both high and low income groups.<sup>39</sup>

## 4. BASIC EXEMPTION FOR CAPITAL INCOME

Capital and labour income can be taxed separately or they can be taxed jointly at the CT rate, while gross labour income is subsequently taxed at additional, progressive PIT rates. The separate taxation of capital income without permitting a basic exemption or allowance (because it accrues mainly to higher-income groups) makes it possible to impose flat final source taxes.

## 5. OFFSET OF NEGATIVE CAPITAL INCOME AGAINST LABOUR INCOME

The joint taxation of capital income and labour income at the capital income tax rate permits negative capital income to be offset against positive labour income. This offset may be desirable since the distinction between labour and capital income tends to get blurred at the level of proprietorships and closely held companies. Accordingly, the profits of unincorporated businesses and closely held companies do not have to be split into a labour and a capital income component if they do not exceed the upper limit of the first labour income tax bracket. If capital and labour income are taxed separately, however, the same effect can be achieved by permitting a tax credit (calculated at the capital income tax rate) for negative capital income against the tax on labour income.

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39. However, this does not apply to partnerships and proprietorships. In the case of partnerships and proprietorships, mixed expenses are netted out against profits before these profits are split into a capital and labour income component. Accordingly, this feature discriminates against costs incurred in earning only labour income.

## 6. CT-PIT INTEGRATION METHOD

The double taxation of distributed profits at the corporate level and the shareholder level can be avoided through a full imputation system. Alternatively, but equivalently, double taxation can be avoided by exempting dividend income at the shareholder level. Under either approach, compensatory taxes should guarantee that dividends are not paid out of exempt profits without having first borne the CT. Double taxation of retained profits is avoided by writing up the acquisition cost of shares by retained corporate profits, net of CT.

## 7. WITHHOLDING TAXES

The single taxation of capital income can be ensured through withholding or source taxes at the corporate level or at the level of other entities paying interest, royalties, or other capital income. In principle, withholding or source tax rates should be set at the level of the CT rate. Consequently, these rates could represent the final tax liability if capital income is taxed separately from labour income and no basic allowance applies.

## 8. UNINCORPORATED BUSINESSES AND CLOSELY HELD COMPANIES

The taxable profits of partnerships, proprietorships, and closely held corporations, conventionally computed, consist of capital and labour income, which accrue jointly. If these profits exceed the first bracket of the labour income tax, they are split into a capital income component and a labour income component and taxed on a current basis.<sup>40</sup> The capital income component is calculated by applying a presumptive rate of return to the value of the gross assets of the business or to equity. Residual profits are considered labour income.<sup>41</sup>

Generally, the presumptive rate of return is set at the level of the hurdle rate of return (the return at which marginal investments are still worthwhile,

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40. This scheme avoids most of the deferral and lock-in effects of the tax that various countries impose on capital gains on substantial shareholdings. Also, the profit-splitting rules of the DIT seem easier to administer than some of the tortuous and arbitrary provisions for preventing the under-taxation of the self-employed, which currently exist in countries without a DIT.

41. Interestingly, Iceland determines labour income first based on administratively set minimum wages, and considers the remaining profits as capital income. Comparing Iceland's approach to the usual method, Matheson and Kollbeins conclude that a switch could increase revenue in a generally progressive manner. Thornton Matheson & Pall Kollbeins, *Allocating Business Income between Capital and Labour under a Dual Income Tax: The Case of Iceland*, Working Paper No 12/263 (Washington: International Monetary Fund, 2012).



*e.g.*, the nominal return on medium-term government bonds plus a premium for entrepreneurial risk). The amount of the presumptive return can then be calculated under either the gross method, by applying the rate to the value for tax purposes of all business assets, or the net method, by applying the rate to the equity capital (*i.e.*, the value of all assets minus liabilities).<sup>42</sup> As explained by Sørensen, the choice between the two methods is largely a choice between investment neutrality and minimization of opportunities for tax arbitrage.<sup>43</sup> Tax arbitrage is less of an issue under the gross method, because the presumptive rate of return is applied to a base that is not influenced by the financing structure of the business. In contrast to the net method, however, the gross method encourages investments by unincorporated businesses and closely held companies, as long as the government sets the presumptive rate of return above the going interest rate.

#### 9. NET WEALTH TAX

If it is considered desirable to tax the *ex-ante* capital income of residents higher than the *ex-ante* income on foreign-owned stocks and bonds, then a net wealth tax could be imposed on privately held assets net of liabilities. Owners of wealth are less mobile than wealth itself.

The most contentious issue under the DIT is the distinction between passive and active owners of closely held corporations. Passive owners are those who finance a business but are not involved in running it, whereas active owners are those who own and manage the business. Only the profits that accrue to active owners have to be split into a capital income component and a labour income component. This difficulty was the main reason why Norway gave up the income-splitting system for closely held corporations and moved to a system with a rate-of-return allowance for all shareholders.<sup>44</sup>

#### B. COMPREHENSIVE BUSINESS INCOME TAX (CBIT)

The hole in the DIT is the inadequate taxation of interest and royalties, which are deductible at the corporate level, not taxable if accruing to foreign debt

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42. Under the gross method, the presumptive return is reduced by the interest actually paid to calculate taxable net capital income. Furthermore, in order to calculate taxable labour income, the gross return is subtracted from total profits and increased by the interest actually paid. Under the net method, in contrast, presumptively determined capital income is subtracted directly from net profits (*i.e.*, net of interest actually paid) to ascertain taxable labour income.

43. "Dual Income Taxes," *supra* note 38.

44. See Part IV-B, below.

holders or exempt entities, and potentially excluded from the PIT return of foreign recipients. The CBIT, proposed by the US Department of the Treasury in 1992, plugs this hole. It treats interest on a par with dividends by precluding a deduction at the corporate level while allowing an exemption for both income items at the level of the recipients, be they individuals, corporations, or exempt entities.<sup>45</sup> This makes the debt-equity distinction irrelevant and greatly reduces the distinction between retained and distributed profits, depending on the treatment of capital gains. In the US version of the CBIT, the rate would be set at the same level as the top PIT rate so that the business income tax would serve as the final withholding tax on dividends and interest.<sup>46</sup> Extending the CBIT to proprietorships and partnerships, though more difficult to achieve, would also make the distinction between corporations and non-corporate entities irrelevant for tax purposes.<sup>47</sup>

The CBIT can be introduced while largely maintaining the current rules for determining taxable profits, including those applicable to depreciation and inventory accounting. Exempt entities and non-residents would be treated like resident individuals or corporations. They would not be eligible for a refund of the CBIT, nor would they have to pay an additional CBIT in the form of a withholding tax or otherwise. Corporations receiving CBIT income simply would not be taxable on such income. To ensure that dividends and interest are not paid out of exempt earnings, a compensatory tax (familiar from imputation systems) would be levied on exempt income made available for distribution as dividends or interest. Capital gains on shares would only be taxed to the extent that they exceed the acquisition cost, stepped up by the corporation's retained profits, net of CT.

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45. The CBIT was proposed by the US Department of the Treasury. See *Taxing Business Income*, *supra* note 31 at 39. The CBIT is similar to a dual imputation system, which treats interest the same as dividends. In other words, interest is not deductible at the corporate level, but debt holders are permitted a tax credit for the underlying CT against their PIT (or CT) on their taxable interest income, grossed up by the tax credit. Alternatively, but equivalently, interest would continue to be deductible when computing taxable corporate profits, but it would be subject to a withholding tax at a rate equal to the CT rate.

46. This alignment of the CBIT rate with the top marginal PIT rate contrasts with the alignment of the capital income tax rate under the DIT with the lower bracket rate of the labour income tax.

47. For probing comparative analyses and evaluations of the DIT, CBIT, and ACE-system, see Peter Birch Sørensen, "Can Capital Income Taxes Survive? And Should They?" (2007) 53:2 CESifo Econ Stud 172; Doina Maria Radulescu & Michael Stimmelmayer, "ACE versus CBIT: Which is Better for Investment and Welfare?" (2007) 53:2 CESifo Econ Stud 294.

The CBIT, as proposed, would reduce the relative tax burden on new equity-financed investment and increase the tax burden on debt-financed investment. Established firms and institutional investors would face relatively high tax burdens, as would tax haven countries, but new, growing firms would be taxed less heavily. The CBIT would eliminate incentives for thin capitalization and the bias against profit distributions. The CBIT is equivalent to a DIT with a final withholding tax on interest payments by businesses. Such a withholding tax could be introduced gradually and pave the way for greater source-based tax coordination. Unlike the DIT, the CBIT has not been introduced in any country, presumably because of its effective taxation of all interest whether paid to domestic or foreign bondholders.<sup>48</sup> A further difficulty with the CBIT is that it would require a special tax regime for banks and other deposit-taking financial institutions, whose income consists mainly of the difference between interest on money lent and interest on money borrowed, unless one wants to relieve the financial sector almost entirely of the CT.

#### IV. CASH-FLOW BASED CORPORATION TAXES

All the CT systems discussed above tax the opportunity cost of capital, often referred to as normal profits. This implies, however, that the level of saving and investment continues to be below the level that would obtain if there were no taxes on capital income. If it is considered desirable that the CT not interfere with the level of economic activity, then only pure profits or economic rents should be taxed. In the literature, a tax on the pure profits of an investment is associated with cash-flow taxation.<sup>49</sup> Under the so-called R-based cash-flow tax, corporations would be denied a deduction for interest and dividends paid, but

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48. Collins & Edgar, *supra* note 27. A similar fate seems to fall on the Business Enterprise Income Tax (BEIT) proposed by Kleinbard. See Edward D Kleinbard, "Rehabilitating the Business Income Tax" *Hamilton Project Discussion Paper: The Brookings Institution* (June 2007), online: <[www.brookings.edu/research/papers/2007/06/corporatetaxes-kleinbard](http://www.brookings.edu/research/papers/2007/06/corporatetaxes-kleinbard)>. The BEIT entails a cost of capital allowance for both equity and debt at the business level, equal to a normal rate of return. This allowance would be taxable at the level of investors, while above-normal returns would be taxed at the business level. Alvin Warren provides a critique of the BEIT. See Alvin C Warren, "The Business Enterprise Income Tax: A First Appraisal" *Tax Notes* 118 (25 February 2008) 921.

49. The Meade Committee has shown that a tax on the flow of funds into and out of any investment is equivalent, in present value terms, to an annual pure profits tax levied over the lifetime of the investment. See UK, Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation*, Report of Meade Committee (London: George Allen & Unwin, 1978) (Chair: Professor JE Meade).

they would be allowed an immediate write-off of the costs of business assets. As a result, the return on marginal investments (those that just make a viable economic return) would not be taxed.<sup>50</sup>

#### A. ALLOWANCE FOR CORPORATE EQUITY (ACE)

The allowance for corporate equity (ACE) is the best-known cash-flow tax in Europe.<sup>51</sup> The ACE system purports to tax only pure profits by providing a deduction from profits, conventionally computed, equal to the “shareholders’” funds (generally, the corporation’s total equity capital, including taxable profits net of CT) multiplied by an appropriate nominal interest rate set by the government but reflecting a normal market rate of return on, say, medium-term government bonds. Since the ACE approximates normal profits, its deduction from total taxable profits means that the CT would be confined to pure profits from infra-marginal investments.

Proponents of the ACE point out that in present value terms, the base of the CT would be identical to the base of an annual pure profits tax for two reasons.<sup>52</sup> First, the ACE permits any schedule of depreciation allowances without altering the present value of the tax payments associated with the cash-flow of an investment. High depreciation allowances result in a lower amount of shareholders’ funds and hence a lower allowance, and vice versa. Second, both corporations and shareholders can borrow at the appropriate nominal interest rate to offset different profiles of tax payments or distributions, respectively. Furthermore, the ACE preserves neutrality under inflation, because the interest rate is set at its full nominal level.

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50. This would ensure investment neutrality if the government would symmetrically share in all gains and losses under unlimited loss carry-forward and backward provisions. McLure and Zodrow offer arguments in favour of the economic and administrative advantages of cash-flow taxation over a conventional income tax. See Charles E McLure Jr & George R Zodrow, “A Hybrid Consumption-Based Direct Tax Proposed for Bolivia” (1996) 3:1 Int’l Tax & Pub Fin 97 at 99.

51. The ACE system was conceived by Boadway and Bruce. See Robin Boadway & Neil Bruce, “A General Proposition on the Design of a Neutral Business Tax” (1984) 24:2 J Pub Econ 231. The Institute for Fiscal Studies gave the system hands and feet. See UK, IFS Capital Taxes Group, *Equity for Companies: A Corporation Tax for the 1990s* (London: Institute for Financial Studies, 1991) (Chair: Malcolm Gammie).

52. Michael Devereux & Harold Freeman, “A General Neutral Profits Tax” (1991) 12:3 Fisc Stud 1; Malcolm Gammie, “Corporate Tax Harmonisation: An ‘ACE’ Proposal: Harmonising European Corporate Taxation Through An Allowance for Corporate Equity” (1991) 31:8 Europ Tax’n 238.

Undoubtedly, the ACE system has attractive neutrality properties. The neutrality conditions, however, are met only if capital markets are perfect. Further, if dividends continue to be taxed under PITs, the ACE system will favour retentions over distributions even more strongly than do partial integration systems. In effect, the ACE system would simply be another form of dividend relief, akin to the dividend-deduction system, but confined to a form of primary dividends. To be fully neutral, the ACE system would require the transformation of the PIT into a personal expenditure tax that exempts all forms of capital income.<sup>53</sup> Moreover, under current PITs, the ACE erodes the source entitlement principle. The ACE might be given consideration if express or tacit coordination on taxing capital income cannot be achieved; but the existing bias against equity is a serious problem.<sup>54</sup>

In comparing the ACE system with the CBIT, Stephen Bond posits that in a world with increasing mobility of physical capital, the user cost of capital may no longer be the only route through which the CT influences the level of domestic investment.<sup>55</sup> If, as is likely, multinational companies dominate in the earning of economic rents, their discrete location decisions would also be influenced by the statutory rate or, more precisely, the Effective Average Tax Rate (EATR, which can be shown to be a weighted average of the statutory tax rate and the Marginal Effective Tax Rate (METR)). Under an equal-yield assumption, the statutory rate would have to be higher under the ACE tax, which would distribute corporate tax payments towards relatively profitable companies. By contrast, a lower rate CBIT would leave profitable multinational companies with lower tax bills. In

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53. Indeed, this kind of reform was recommended by the IFS Capital Taxes Group in the form of an extended personal equity plan. See UK, IFS Capital Taxes Group, *Neutrality in the Taxation of Savings: An Extended Role for PEPs* (London: Institute for Fiscal Studies, 1989) at 66 (Chair: Malcolm Gammie).

54. Belgium exempts the normal return from CT in the form of an ACE, called “notional interest on corporate capital.” The interest is set at the rate payable on ten-year government bonds issued in the previous year; presumably, this rate approximates the normal rate of return on capital. The rate—2.63% in 2014, but 3.13% for SMEs—is applied to the corporation’s “risk capital” (*i.e.*, its equity shown on the balance sheet). Belgium introduced the ACE system to stimulate the self-financing capability of corporations. In an analysis of the Belgian system, Nils aus dem Moore shows that the expected reduction in leverage is confined to large firms. See Nils aus dem Moore, “Tax and Corporate Financing Decisions: Evidence from the Belgian ACE Reform” (Paper delivered at the Royal Economic Society Annual Conference, 9 April 2014), [unpublished]. For some time, Croatia had an ACE system. See Michael Keen & John King, “The Croatian Profit Tax: An ACE in Practice” (2002) 23: 3 *Fisc Stud* 401.

55. “Levelling Up or Levelling Down? Some reflections on the ACE and CBIT proposals, and the future of the corporate tax base” in Cnossen, *Taxing Capital*, *supra* note 38, 161 at 167.

this situation, a government in an open economy may achieve a higher level of domestic investment by lowering the statutory rate and accepting a broader tax base, even though this results in a higher cost of capital. In a broader and more probing analysis, Ruud De Mooij and Michael Devereux argue that a combination of ACE and CBIT reforms can be designed to be revenue neutral and welfare improving through smaller financial distortions.<sup>56</sup>

## B. RATE OF RETURN ALLOWANCE (RRA)

The Mirrlees Review's proposal for a Rate of Return Allowance (RRA) for all capital income extends the ACE to non-corporate investments.<sup>57</sup> In other words, the Mirrlees Review proposes a reduction of the gross rate of return on all investments, in whatever form, with a normal rate of return equal to, say, the ACE.<sup>58</sup> Clearly, the RRA transforms the CT/PIT into an expenditure tax or a VAT, which does not tax the normal return either, but only the supra- or infra-marginal return, also called business cash-flow. Abstracting from exemptions and differentiated rates, this makes the VAT a neutral tax that does not influence inter-temporal consumption choices, and hence decisions to save or invest now or in the future. As the Mirrlees Review points out, above-normal returns can be taxed progressively since doing so does not influence savings and investment behaviour.<sup>59</sup>

The goal of neutral capital income taxation can also be achieved by what the Mirrlees Review, following the US Department of the Treasury,<sup>60</sup> calls the *Exempt/Exempt/Taxed* (EET) method and the *Taxed/Exempt/Exempt* (TEE) method.<sup>61</sup> The EET-method exempts savings out of current income along with the return on the savings, but taxes withdrawals in full. For example, this is

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56. EC, Taxation Papers, *Alternative Systems of Business Tax in Europe: An applied analysis of ACE and CBIT Reforms* (Luxembourg: Office for Official Publications of European Communities, 2009) at 11. The Mirrlees Review has shown that the adoption of ACE financed by broadening the base of the VAT, results in an increase of investment with 6.2% and of wages with 1.7%. Further, employment would increase with 0.2% and GDP with 1.4%.

57. "Dimensions of Tax Design" in Stuart Adam et al, eds, *The Mirrlees Review*, vol 1 (Oxford: Oxford University Press, 2010); "Tax by design" in James Mirrlees et al, eds, *The Mirrlees Review*, vol 2 (Oxford: Oxford University Press, 2011).

58. Alan J Auerbach, "The Mirrlees Review: a U.S. Perspective" (2012) 65:3 Nat'l Tax J 685 at 691. Boadway and Tremblay devise a detailed proposal for transitioning from a corporate tax to a rent-based tax in Canada. See Robin Boadway & Jean François Tremblay, *Corporate Tax Reform: Issues and Prospects for Canada*, online: <[mowatcentre.ca/corporate-tax-reform](http://mowatcentre.ca/corporate-tax-reform)>.

59. *Supra* note 57.

60. *Blueprints*, *supra* note 28.

61. *Ibid* at 13.

the treatment that applies to savings for retirement purposes, such as pensions. The second approach, the TEE-method, can be likened to the tax treatment of durable consumer goods, such as cars and houses. The savings for the purchase are taxed but neither the return nor the sale is subject to the PIT.

On the assumption of a constant PIT rate and a constant rate of interest (discount rate), the present value of tax payments and disposable income, separately and jointly, will be the same under both methods. But if these assumptions are relaxed, one disadvantage of the TEE-method is that above-normal returns (as reflected in capital gains) are not taxed. On the other hand, the drawback of the EET-method is that it is sensitive to changes in tax rates, and this sensitivity may influence propensities to save. The deduction of an ACE or RRA at the business or individual level does not suffer from these shortcomings, but these allowances have to be set by government (thus being susceptible to pressure by lobby groups), and the relating assets have to be monitored.<sup>62</sup>

In practice, the choice between the ACE/RRA, the EET, and the TEE will depend on the kind of asset being taxed. The ACE system seems to be the method of choice to ensure investment neutrality at the business level, while EET, TEE, and RRA make it possible to achieve approximately equal treatment at the level of the individual with respect to (a) pensions (under EET, pension fund contributions and returns are exempt from tax but payouts are taxed); (b) savings deposits (under TEE, these are taxed when deposits are set aside out of income, but interest and withdrawals are exempt under the assumption that deposits do not generate above-normal returns); and (c) investments in shares, bonds, and real estate (under RRA, these are taxed when savings are made, returns that exceed the normal return are taxed taking into account the CT that has already been levied in the case of shares, and sales are exempt from taxation). Under the Mirrlees proposal, the exemption of the normal return paves the way for the integration of the PIT (including capital income) and social security contributions without income ceilings.

### C. FLAT TAX

Cash-flow taxation is also achieved under the flat tax, a subtraction-VAT type of origin-based direct tax, which has been proposed in the United States as a replacement for the current PITs and CTs.<sup>63</sup> Under the flat tax, the value added, which consists of wages and business cash-flow, is determined by deducting purchases (including investment goods) from sales. Subsequently, wages are

62. *Auerbach, supra* note 58.

63. Robert E Hall & Alvin Rabushka, *The Flat Tax*, 2d ed (Stanford: Hoover Press, 1995).

deducted and taxed separately at the employee level, which permits a basic exemption and effective progressivity. What remains are pure profits, which means that the return on marginal investments would be exempted. The flat tax is attractive politically, because businesses view it as a tax on consumption or wages, while consumers or employees consider the business cash-flow component as a tax on business. Apart from the fear of the unknown, transitional difficulties and international problems (*e.g.*, obtaining a foreign tax credit for the tax paid) seem to preclude adoption of the flat tax. The flat tax would also have to consider the treatment of the return on individually held assets, such as real estate.

## V. WHICH WAY FORWARD?

The previous sections have shown that there is quite an array of CT/PIT regimes to choose from. This section sums up the major pros and cons and argues that the DIT is probably the preferred CT regime.

### A. MAJOR CHOICES

To sum up the previous arguments, corporate source income consists of the return on equity (*i.e.*, retained and distributed profits) and the return on debt (*i.e.*, interest). The return on equity consists of the normal or hurdle rate of return, which an entrepreneur earns on his or her marginal investment, and the above-normal or infra-marginal return, which can be attributed to favourable head starts, patents, inventions, or some form of natural monopoly—in other words, entrepreneurial advantages not enjoyed by competitors. The normal return is equal to the world rate of interest, adjusted for inflation and risk.

Traditionally, the return on equity is taxed in full at the corporate level, while a deduction from taxable profits is permitted for interest. There is agreement in the tax profession that the above-normal return on corporate equity should be taxed since taxing it does not influence behaviour. However, there is no agreement on the taxation of the normal or hurdle rate of return on capital, whether equity or debt (taxing the normal or hurdle return reduces the overall level of investment). Accordingly, a distinction can be made between income-based forms of CT, which include the normal return in the tax base, and cash-flow forms of CT, which confine the tax base to above-normal returns or pure profits by permitting the immediate expensing of investment but not allowing a deduction for interest.

Both income-based and cash-flow-based systems must face the consequences of the interaction between the CT (which may or may not include the normal return in the tax base) and the PIT (which may double tax the normal return or



undo the exemption under the CT cash-flow tax). Under the income-based CT system, the double taxation of distributed profits can be prevented by grossing-up net dividends with the CT attributable thereto (*i.e.*, the imputation system), by permitting a deduction for dividends paid (*i.e.*, the dividend-deduction system) or, yet, by not taxing these dividends (or taxing them partially) at the corporate level (*i.e.*, the split-rate system).

Further, double taxation of retained profits subject to capital gains tax at the shareholder level can be prevented by permitting shareholders to write up the base of their shares with the amount of retained corporate profits, net of CT, attributable to their holdings. Using a schedular approach, either corporate source and other capital income are taxed separately from labour income under the DIT or no deduction is allowed for interest at the corporate level under the CBIT, while this interest is not taxed at the level of the recipient.

Interest already being deductible, taxation of the normal return on equity can be prevented under cash-flow forms of the CT by allowing a deduction from corporate profits (conventionally computed) of a presumptive rate of interest on equity under the ACE system. The same result would be achieved under a flat tax, which permits the deduction of wages (subsequently individualized) from value added, and thus only taxes business cash-flow (as does a VAT, in addition to wages). Cash-flow forms of the CT must be extended to PITs to prevent the ACE credit from becoming a discriminatory form of taxing retained profits at a lower rate than distributed profits or other forms of capital income. This can be achieved comprehensively under a personal expenditure tax the base of which is confined to consumption or an ACE-equivalent RRA at the individual level, as proposed by the Mirrlees Review.

## B. WHAT IS THE PREFERRED REGIME?

Nearly all CT/PIT regimes in the OECD area tax the normal return on capital on a source basis through the CT, or on a residence basis under the PIT.<sup>64</sup> These practices find support in the tax literature, which has argued that the optimality arguments for not taxing the normal return on capital are not persuasive if bequests are not taxed and present and future consumption are not weakly separable.<sup>65</sup> Further, it is pointed out that the distortion on account of the taxation of the normal return is small and that market imperfections may make

64. OECD, Tax Database, *Explanatory Annex, Part II: Taxation of Corporate and Capital Income* (2014), online: OECD Tax Database <[www.oecd.org/ctp/tax-policy/Corporate-and-Capital-Income-Tax-Explanatory-Annex-2014.pdf](http://www.oecd.org/ctp/tax-policy/Corporate-and-Capital-Income-Tax-Explanatory-Annex-2014.pdf)>.

65. Bernard Salanié, *The Economics of Taxation* (Cambridge, Mass: MIT Press, 2003) at 147.

the taxation of capital income attractive. Also, capital income could be a proxy for human capital, which is not taxed,<sup>66</sup> or a substitute for an age-dependent tax on labour income.<sup>67</sup> James Banks and Peter Diamond argue that taxing capital income reduces wealth accumulation and so encourages labour supply, because leisure is a normal good.<sup>68</sup> A review of the arguments reveals that the following seven practical considerations seem to dominate the choice of the most appropriate CT regime.<sup>69</sup>

1. The CT rate applicable to corporate source income, as well as other capital income, should be moderate and uniform. A moderate rate is favourable to highly mobile international capital, yet it taxes firm-specific and, especially, location-specific rents.
2. A moderate but uniform rate reduces distortions of the form in which business is conducted (proprietorships, closely held or publicly held corporations), how the business is financed (equity or debt), and which payout policy (dividends or profit retention) is pursued. The moderate rate should reduce the lock-in effect of a tax on realized capital gains and make adjustments for the effects of inflation less urgent.
3. The uniform rate should make tax arbitrage less attractive, because the tax savings from converting highly taxed income (dividends, for instance) into lower taxed income (capital gains, for instance) are smaller. International tax avoidance activities, such as the manipulation of transfer prices, would be less lucrative.
4. Moderate taxation minimizes clientele effects that occur under a progressive capital income tax, which induces high-income earners to specialize in holding assets whose returns accrue in tax-favoured forms. These effects distort ownership patterns. Furthermore, patterns of saving and investment are distorted under a progressive capital income tax if a large portion of private savings is channelled into tax-favoured investments (*i.e.*, owner-occupied housing and retirement savings accounts) but other forms of capital income are taxed highly.

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66. Søren Bo Nielsen & Peter Birch Sørensen, "On the optimality of the Nordic system of dual income taxation" (1997) 63:3 J Pub Econ 311 at 312.

67. Bas Jacobs, "From Optimal Tax Theory to Applied Tax Policy" (2013) 69:3 FinanzArch 338.

68. "The Base for Direct Taxation," in Adam et al, eds, *Dimensions of Tax Design*, *supra* note 7, 548.

69. George R Zodrow, "Capital Mobility and Source-Based Taxation of Capital Income in Small Open Economies" (2006) 13:2-3 Int'l Tax and Pub Fin 269.

5. Capital income should be taxed separately from labour income, so that it is not held hostage to the high, progressive PIT (including social security contributions) on labour income. In fact, a separate capital income tax provides governments with an additional policy tool to respond to changes in international capital mobility and the tax policy of other countries.
6. The taxation of corporate profits allows the use of the treasury-transfer argument (meaning that the exemption of corporate profits would favour the treasury of the recipient's country if that country taxes the return in full) and maintains the backstop function of the PIT by discouraging the use of the corporate form to shelter labour income from higher PIT rates.
7. Preferably, the taxation of corporate source income in individual countries should be in line with foreign tax regimes and attuned to business and accounting practices.

These considerations point towards a DIT or towards a CBIT that is equal to a DIT with a final withholding tax on interest at the corporate level, fixed at the CT rate.<sup>70</sup> The drawback of the CBIT is that it increases capital costs and dampens debt-financed foreign investment. By contrast, actual DITs do not tax the interest on inbound capital, which does not seem advisable in the absence of international coordination. The DIT also seems to have the edge since capital income other than business profits is included more obviously in its base. A major advantage, too, is that there is actual experience with it, as described below.

### C. EXPERIENCE WITH DIT IN THE NORDIC COUNTRIES

In the early 1990s, the DIT was successfully introduced in Norway, Finland, and Sweden.<sup>71</sup> As shown in Table 2, corporate profits and other capital income are taxed at the same rate in Norway, but other capital income is taxed at somewhat higher rates in Finland and Sweden. In all three countries, the labour income tax rates are progressive and include local taxes, social security contributions (if not

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70. Brooks discusses these and other arguments, noting that the inequity of a low rate DIT can be mitigated by either the enactment of a gift and estate tax or the imposition of a net wealth tax. See Neil Brooks, "An Overview of the Role of the VAT, Fundamental Tax Reform, and a Defence of the Income Tax," in Richard Krever & David White, eds, *GST in Retrospect and Prospect* (Wellington: Brookers, 2007) 597.

71. Vidar Christiansen provides an update on developments in Norway. See Vidar Christiansen, "Norwegian Income Tax Reforms" (2004) 2:3 CESifo Dice Report 3. The OECD provides an analysis of the Finnish system. See OECD, *OECD Economic Surveys: Finland*, Chapter 3, (2008).

deductible from income), and church taxes, if applicable. Finland and Sweden tax capital and labour income entirely separately, permitting the imposition of flat final source taxes, as is actually done in Finland. In Norway, the two forms of income are taxed jointly at the CT rate, enabling the application of basic allowances to both kinds of income. No tax is withheld on interest paid on inbound capital or on royalties paid on foreign patents. Only Norway imposes a net wealth tax.

The most interesting features of the Nordic DIT concern the treatment of corporate profits, distributions and retentions, on the one hand, and that of closely held companies and unincorporated businesses, on the other. In Norway, the double taxation of profit distributions of publicly held companies used to be prevented under a full imputation system. To prevent the double taxation of retentions, the cost base of shares was stepped up by corporate profits net of CT for capital gains tax purposes. But over the course of the years it was argued that there was no economic reason for mitigating the double taxation of above-normal returns on capital. Accordingly, in 2006 Norway introduced the “shielding method” (in other words, an RRA), under which only the normal return on capital, called the risk-free return, is exempt from the additional PIT.<sup>72</sup>

The risk-free return is calculated by applying a fixed interest rate (equivalent to the after-tax return on three-month government bonds) to the cost base of shares. The risk-free return is deductible when calculating the amount of dividends and capital gains, if realized, subject to PITs. Unused risk-free allowances are added to the base for calculating future allowances. In this way, unused allowances are effectively carried forward, with interest and tax levied only on realized income that exceeds the accumulated sum of unused allowances. These rules are important for the neutrality properties of the system. Further, interest and royalties are subject to the capital income tax rate. So is the imputed return on the value of privately held immovable property, but there is no tax on the imputed rental value of owner-occupied housing. Generally, therefore, Norway does not distinguish between capital and labour income, but between the normal return on capital, which is taxable at the capital income tax rate, and all other income.<sup>73</sup>

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72. Peter Birch Sørensen, “Neutral Taxation of Shareholder Income” (2005) 12 *Int'l Tax & Pub Fin* 777 at 783.

73. Edward D Kleinbard, “An American Dual Income Tax: Nordic Precedents” (2010) 5:1 *Nw J Law & Soc Pol* 41 [Kleinbard, “American Dual Income Tax”]. Kleinbard notes that Norway now has a flat tax on all income combined with a progressive surtax on gross labour income.

TABLE 2: DUAL INCOME TAXES IN NORWAY, FINLAND, AND SWEDEN, 2010

Particulars	Norway	Finland	Sweden
<b>Year of introduction</b>	1992	1993	1991
<b>a. Tax rates (%)<sup>a</sup></b>			
Corporate profits	27	20	22
Other capital income	27	30/32	30
Labour income <sup>b</sup>	27–47.2/50.4	21.82–52.57	31.86–56.86
<b>b. Costs of earning income</b>	Deductible at basic rate	Deductible at basic rate	Deductible at basic rate
<b>c. Basic allowance for capital income</b>	Yes	No	No
<b>d. Offset of negative capital income against labour income</b>	In first bracket	Through tax credit at basic rate	Through tax credit at basic rate
<b>e. CT-PIT integration method</b>	Shielding method	Basic exemption	No integration
<b>f. PIT on corporate profits (%)</b>			
Distributed profits	27% on dividends in excess of risk-free return calculated as cost base of shares times fixed interest rate (after-tax return on 3-month government paper)	<i>Quoted shares</i> Exemption of 15% of dividends, remaining 85% taxed as capital income <i>Unquoted shares</i> 25% taxed as capital income up to 8% ceiling; remaining dividend exempt up to €150,000; excess exempt up to €15,000, remainder taxed as capital income	<i>Quoted shares</i> 30% <i>Unquoted shares</i> See below
Retained profits	27% on realized capital gains in excess of (accumulated) unused risk-free amounts	30/32% on realized capital gains	25% on realized capital gains

TABLE 2: DUAL INCOME TAXES IN NORWAY, FINLAND, AND SWEDEN, 2010

Particulars	Norway	Finland	Sweden
<b>g. Withholding taxes (%)<sup>c</sup></b>			
Dividends			
Portfolio	15	15	15
Direct investment	0; 10; 15	0; 10; 15	0; 10; 15
Interest	–	–	–
Royalties	–	0	–
<b>h. Mandatory income-splitting</b>			
Closely held companies <sup>d</sup>	27%CT + 27%PIT on 72% of distributed profits minus risk-free amount	See above under unquoted shares	Active shareholders: 20% on profits deemed to be return on equity + labour income tax on balance up to SEK 5,121.000 in 2014 Passive shareholders: 25%
Partnerships and proprietorships	27% on risk-free amount + 27-50.4% on profits in excess of risk-free amount	20% of net capital is considered remainder is labour income	30% on 'interest' on equity + 22% on retained profits + labour income tax rate on withdrawals with credit for earlier 22%
<b>i. Net wealth tax</b>	1%	None	None

SOURCE: Author's compilation from IBFD on line, which lists Eivind Furusetth as the author for the Norwegian CT/PIT system, and Laura Ambagtsheer-Pakarinen for Finland and Sweden's CT/PIT systems.

- Including local taxes if levied, but ignoring some low taxes or exemptions for special jurisdictions, persons or income items.
- Including non-deductible social security contributions which increase marginal tax rates.
- Non-residents in treaty countries.
- In Norway, these rules apply to all shareholders, not just to shareholders in closely held companies.

As pointed out by Sørensen, imposing an additional layer of tax on above-normal returns eliminates the incentive for income shifting under the DIT in a manner that does not distort investment incentives.<sup>74</sup> As a result, the current Norwegian treatment obviates the need to make a distinction between active shareholders (earning labour income in addition to receiving dividends) and passive shareholders in closely held companies, which had become a contentious issue.<sup>75</sup>

Since the capital income tax is confined to normal returns, the shareholder income tax is generally neutral with respect to investment and financing decisions and does not induce shareholders to postpone realization of their shares (*i.e.*, lock-in effect) in order to defer capital gains tax, even though the tax is levied only on realization. The weakness of the Norwegian shareholder income tax is that it does not allow the full offset of losses in all circumstances. This may deter risky investments in innovative activities.<sup>76</sup>

Finland permits a basic exemption of 15% for dividend income at the level of holders of quoted shares and taxes the remaining profit distribution as well as realized capital gains at the capital income tax rate of 30/32%. The distinction between quoted and unquoted shares obviates the need to separate closely held companies from publicly held companies. On the other hand, Sweden requires active shareholders who own and manage their closely held company to divide their profits into a capital and a labour income component. Interestingly, unincorporated businesses in Sweden are taxed under the fence model, that is, the labour income tax applies only to withdrawals. Table 2 provides further details.

## VI. CONCLUDING COMMENTS

On the basis of a review of various CT/PIT regimes, this article concludes that the DIT is to be preferred. It is best attuned to the reality of capital mobility and is not held hostage by the tax on labour. Levied at a uniform, flat rate, it minimizes opportunities for tax arbitrage.

74. Sørensen, "Dual Income Taxes," *supra* note 38 at 85.

75. See Annette Alstadsaeter, "The Achilles Heel of the Dual Income Tax: The Norwegian Case" (2007) 20:1 Finnish Econ Papers 5. Active shareholders earn labour income in addition to receiving dividends. This distinction remains a contentious issue in Finland, as shown by Pirttilä and Selin. See Jukka Pirttilä & Håkan Selin, "Income Shifting within a Dual Income Tax System: Evidence from the Finnish Tax Reform of 1993" 113:1 Scand J of Econ 120. Also, the distinction between labour and capital income is still relevant for unincorporated businesses, but only if the sum exceeds the first bracket of the labour income tax schedule.

76. Interestingly, the Mirrlees Review proposes to exempt the normal return through a RRA, while the Norwegian DIT taxes it, albeit at the lower capital income tax rate. See Rachel Griffith, James Hines & Peter Birch Sørensen, "International Capital Taxation" in Adam et al, eds, *Dimensions of Tax Design*, *supra* note 7, 914 at 987.

Norway has the most consistent and neutral version of the DIT because it makes a distinction between the normal return on capital and all other income.<sup>77</sup> Other countries have also introduced DIT elements into their tax systems.<sup>78</sup> Austria, Belgium, and Italy levy final flat rate withholding taxes on capital income, while the Netherlands and Greece either tax capital income presumptively or exempt dividend income from PIT. Members of the German Council of Economic Experts—Hans-Werner Sinn, Christoph Spengel, and Wolfgang Wiegard—have each proposed variants of the DIT for Germany.<sup>79</sup> Christian Keuschnigg and Martin Ditz did so for Switzerland,<sup>80</sup> while Rachel Griffith, James Hines, and Peter Sørensen touch on the issues in the Mirrlees Review.<sup>81</sup> Kleinbard provides a very thorough analysis of the DIT in the US context.<sup>82</sup>

The case for introducing a DIT in Canada has been made by Sørensen, who emphasizes that the lower rate on capital income would strengthen incentives for saving and investment.<sup>83</sup> As a first step, he suggests that a separate, low, flat tax rate be imposed on personal capital income, without including in its base the imputed returns to business assets of the self-employed. Subsequently, and after considering the various methods of income-splitting found in the Nordic countries, the self-employed could be given the option to include an imputed return to their business assets in the capital income tax base. Further, the flat rate on capital income should be aligned with the CT rate to promote consistent taxation of all returns to capital. Specifically, nominal capital gains should be taxed in their entirety, allowing the imputation system to be abolished. Kirk Collins and Tim Edgar briefly discuss the DIT that Sørensen suggests for Canada, but a full treatment has not yet been undertaken.<sup>84</sup> Will Neil Brooks pick up the gauntlet?

77. Income from immovable property forms an exception to this rule, since it is taxed at progressive rates if privately held.

78. Bernd Genser & Wolfgang Eggert, "Dual Income Taxation in EU Member Countries" (2005) 3:1 CESifo DICE Report 41; Bernd Genser & Andreas Reutter, "Moving Towards Dual Income Taxation in Europe" (2007) 63:3 FinanzArchiv 436.

79. Wolfgang Wiegard, "Consolidate Public Finances- Reform the Tax System: Annual Report 2003/2004" in ZEW Economic Studies et al, *Dual Income Tax: A Proposal for Reforming Corporate and Personal Income Tax in Germany* (Physica-Verlag Heidelberg, 2008); Hans-Werner Sinn, *Ist Deutschland noch zu retten?*, 4th ed (Munich: Econ, 2003); Christoph Spengel & Wolfgang Wiegard, "Dual Income Tax: A Pragmatic Tax Reform Proposal for Germany" (2004) 2:3 CESifo Dice Report 15.

80. "A growth oriented dual income tax" (2007) 14:2 Int'l Tax & Pub Fin 191 at 193.

81. Griffith, Hines & Sørensen, *supra* note 79.

82. Kleinbard, "American Dual Income Tax," *supra* note 73.

83. "The Nordic Dual Income Tax: Principles, Practices, and Relevance for Canada" (2007) 55:3 Can Tax J 557 at 592.

84. *Ibid* at 590; *supra* note 31.