

Taxing Corporate Income: Comments

By Jack M. Mintz¹

The primary focus of “Taxing Company Income”, written by three eminent authors, is to reconsider the Meade Report’s recommendation to tax corporate rents in light of evolving changes to the UK economy since 1978. Wisely, the authors focus on the impact of global economic integration on company taxation policy. I would agree that one cannot consider company taxation without thinking about international issues.

After examining a rich array of possible tax bases, the authors come to an almost stark conclusion that little will work properly in raising revenue as businesses will shift income to low-tax jurisdictions – whether the tax is based on income or on rents on a source basis. Eventually, international considerations shall force governments to move towards a corporate tax that exempts exports and taxes imports, based on the destination principle.

I believe that we are far from that point yet. Despite the rapid growth in cross-border investments since 1990², corporate income tax revenues as a share of GDP have been remarkably robust among OECD countries in the past 25 years (see Mintz and Weichenrieder (2007)). Governments are not about to abandon a tax base that raises almost 10 percent of their needs today.

I think this reflects a reality that capital markets are not quite as internationally integrated as sometimes assumed. Many financial studies show investor “home bias” remains partly a result of regulations that limit the cross-border ownership of shares.³ Further, while one cannot ignore the open economy in evaluating corporate policy in today’s economy, one cannot forget the possible arbitrage between corporate and personal tax bases within the domestic economy. Smart tax arbitragers will work out schemes to shift labour into capital income or develop tax structures that allows businesses to escape paying tax when differential taxes apply – not just at the international level but also within the domestic economy⁴.

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² In 1990, cross-border investment flows of foreign direct investment among OECD countries was about US\$200 billion, rising to over US\$2 trillion by 2000, falling back to over \$600 billion by 2004 (all numbers expressed in 2000 dollars). See Organization of Economic Cooperation and Development, Statistics, (2006).

³ See, for example, Helliwell (1998) and Helliwell and McKittrick (1999) who suggests that investment and savings rates are correlated among countries although within Canada there is no such correlation. Recent deregulation in the Europe Union making it easier for investors to trade across member state boundaries will likely increase capital market integration.

⁴ A perfect example of how arbitrage can lead to distortions in the corporate sector was the conversion of corporations into income trusts in Canada that led to 17 percent of the stock market capitalized in the form of trusts that distributed most of their cash flows to their investors. The incentive to create an income trust was to eliminate the non-integrated part of the corporate income tax for taxable investors, tax-exempts and

Indeed, I am not even sure it is right to emphasize only a “corporate tax” when businesses have developed enterprise groups with corporations, unlimited liability corporations, limited liability partnerships and trust arrangements to run business organizations. My preference has been to refer to business taxes rather than corporate taxes to keep in mind the complexity of business relationships in today’s environment. Consistent with the paper, however, I shall focus on corporations that are by and large the most important form of business organization in the UK economy.

The question in my view is whether a better tax base can be developed for corporate taxation that would improve the efficiency and fairness of the tax system. In my view, the Meade (1978) and the US Treasury (1977) reports got the essential argument right – eliminating the inter-temporal distortion of taxes by replacing a corporate income tax with a cash flow tax can arguably be efficient, fair and simple. This argument has not changed and has led to several tax reforms based on including cash flow taxes in the resource sector (Australia and Canada) and a deduction for the imputed cost of equity financing such as Croatia, Belgium and Italy.

The important contribution of Auerbach, Devereux and Simpson is that they make a case for a destination-based cash flow tax in order to deal with international issues, a point that received little attention at the time when the Meade report was written. I will return to this point soon below as I do believe that good reasons exist for an origin-base approach but practicality would push governments to some extent to exempt exports and tax imports under a cash flow tax or value-added tax, which is similar except that payroll costs are included in the tax base.

The Purpose of the Corporate Tax

Going back to the Canadian Carter report (Canada (1966)), the purpose of the corporate tax has been twofold: (i) to be a backstop to the personal income tax and (ii) to tax foreigners on their income earned in Canada. The Canadian Technical Committee on Business Taxation (Canada (1997)) added the concept that the corporate profit tax could be a surrogate for user fees when such levies are not applied in full for administrative or equity reasons.

Under a rent tax, as developed by the Meade report, the basic purpose of the corporate tax remains the same in principle. Taxing rents can arguably be more efficient by removing the inter-temporal tax distortion on investments. A corporate rent tax could still be required as part of the overall expenditure tax. Otherwise, the rents could accrue to individuals as exempt income. Similarly, to ensure that rents accruing to foreigners are taxed, a corporate rent tax is needed. And, to the extent that corporate rents reflect

foreign investors but at the cost of adopting a business structure which required taxable income to be fully distributed to minimize taxes. Further announced conversions by two large telecommunications companies led to government action to put a special tax on publicly-traded trusts after October 31, 2006. See Mintz (2006). Arbitrage was especially driven by domestic investors, especially pension plans, and foreign investors.

benefits from public services provided to firms priced below cost, a rent tax would also be appropriate to apply.

I would argue that the globalization of production does not change much the purpose of corporate taxation, whether on rents or income. Design issues are much more complex with respect to administration and compliance, for sure, and the Auerbach, Devereux and Simpson paper is spot-on in emphasizing its importance. However, despite the challenges imposed, the traditional arguments for corporate taxation do not disappear.

Origin versus Destination-base Cash Flow Tax

The authors argue for a destination-base cash flow tax on the presumption that it is too difficult to levy one on an origin-base principle. The origin-base cash flow tax would apply to exports and allow imports to be deducted from the tax base – this is the approach being currently used for the Italian IRAP and Hungarian regional taxes (which do not allow payroll taxes to be deducted from the base). The alternative, a destination-based cash flow tax, exempts exports and taxes imports.

A destination-base cash flow tax has the virtue of withholding worldwide rents according to consumption while an origin-base tax withholds rents according to production.

As sales taxes (equivalent to cash flow taxes on payroll⁵ and economic rents), the two approaches can be equivalent in economic effects under certain conditions so long as all goods are taxable and cross-border ownership of rents do not occur. Under an origin-base tax, the exchange rate will be depreciated, reflecting the tax on exports and deduction given for imports compared to the destination-base tax. Otherwise, they will have differential effects – for example, all goods may not be taxable and rents may be claimed by non-residents (see Lockwood, de Meza, and Myles (1994)).

As the authors note correctly, origin-base taxes could result in potential transfer pricing problems although this argument can be overstated. For some products such as oil and gas, the application of the comparable uncontrolled pricing method – or its alternatives – is not a serious problem since quality differences are easily observable and priced in markets. However, rents arising from research, marketing and branding (intangible income) are much more difficult to price for related-party transactions within multinational groups since comparable transactions are difficult to find. A destination-base cash flow tax avoids the transfer pricing issues since transaction values with the rest of the world do not get included in the tax base. However, a country does give up the right to tax rents at source, which it might wish to do for other reasons as specified below.

While transfer pricing reasons might push governments to move towards a destination-based tax, other arguments can be made for an origin-based tax that would need to be considered. Below are three arguments for an origin-based tax.

⁵ It is assumed here that labour is immobile among countries.

The Corporate Tax in Relation to the Personal Tax

If the Meade report recommendations for an expenditure tax are adopted, an important question is whether a business level tax is required to ensure that expenditure is taxed at the personal level.

Under the expenditure tax, two approaches can be used to tax consumption. The first is to allow individuals to deduct savings invested in registered assets from the tax base and add the withdrawals from registered assets to the tax base. The second is to exempt the yield on savings – no deduction is provided for savings and no tax is imposed on withdrawals. A very important point raised in the Meade report is that both approaches are useful to apply since it allows individuals to average their expenditure base given that a progressive rate schedule would be used for personal tax purposes.

The corporate tax on rents would not be required for the registered asset approach but would be needed for the non-registered asset approach. Otherwise, taxes on business rents could be avoided if people own assets that give rise to rents in the non-registered form. Given that the corporate rent tax would need to be applied on a source basis, such rents would be double-taxed for owners of registered assets while singly taxed for owners of non-registered assets. Thus, some form of tax credit could be considered for owners of registered taxes as an offset for the corporate rent tax. Presumably, the tax credit could be provided using the Australian approach of providing a credit for dividends equal to the actual tax paid at the corporate level.

So far so good. However, the world is not so simple. As the three authors review, one issue is whether the corporate tax should be applied to only real transactions (R-base equal to revenue net of employment compensation and capital expenditures) or real and financial transactions (the R+F base would include borrowings added and repayments of interest and principal deducted from the tax base). Leaving aside some technical complexities associated with financial derivatives, the R+F base is certainly feasible to consider and has been even subject to analysis for a VAT applied to financial transactions. A different variation of the approach – the tax imposed on profits net of an imputed deduction for equity shows that a rent tax can be levied at the corporate level including financial transactions.

A further issue is whether the rent tax should be applied generally to corporations, partnerships, trusts and other types of businesses. Business income earned by individuals would be subject to tax under the personal expenditure tax but within business sector, different entities are possible to create that would not be a corporation but effectively operate on a similar basis. Corporate organizations could also be developed to attract investors with different tax preferences. If some business organizational forms are tax-free under the rent tax, they have the capacity to issue securities to attract certain tax-preferred investors. A more general approach to rent taxation ensures a level playing-field among different types of business organizations. Again, as experience has recently shown in Italy and Hungary that business value taxes (Bird and Mintz (2001)) applied to

rents and payroll could be applied generally to corporations, non-profits, partnerships and trusts.

Can we ignore the linkage between the personal and corporate side? Even in a small open economy, the absence of a business level tax would provide significant opportunities for persons to avoid the expenditure tax by leaving rents in the business level. In particular, labour income, including employee profit-based compensation, could be structured as stock grants to avoid personal taxes on labour earnings. Further, entrepreneurs controlling private and public corporations obtain significant earnings from their corporate investments that should be subject to a personal cash flow tax. One could require rules to treat all forms of compensation as taxable earnings although a corporate rent tax makes sure the tax is applied generally.

A rent tax should therefore be applied in a neutral manner without providing special exemptions, tax credits or other tax preferences to certain business activities to avoid tax. Otherwise, rents available for personal consumption could escape taxation. In this sense, the rent tax should be broad in application, a principle equally applicable to a corporate income tax.

The other important question is whether a personal cash flow tax needs to be applied on an origin or destination basis. An advantage of a cash flow tax on earnings, compared to a destination-base sales tax such as the VAT, is that an individual's consumption, whether at home or abroad, will be captured with a tax on earnings rather than sales taxes withheld domestically by businesses.

If international transactions are excluded from the cash flow base either for personal or corporate purposes or both, some earnings could be exempt. Some might be able to arrange labour compensation in foreign jurisdictions that might be exempt from tax and those with earnings from businesses (sole proprietorships or partnerships) could earn foreign-source rents that would escape personal cash flow tax. To the extent that the cash flow destination-base approach applies only to corporate earnings, individuals with foreign-source labour earnings or rents, could avoid the personal cash flow tax on this income by having the corporation, owned on a non-registered basis, earn it instead.

Thus, origin-base cash flow taxes might be preferable to apply if the concern is to withhold earnings that would otherwise be avoided at the personal level.

The Corporate Rent Tax as a Withholding Tax on Foreign Investors

In many countries, including the UK, some industries earn origin-based rents especially from irreproducible factors of production, such as natural resources, and perhaps, protection from competition. In some recent work, I have found that countries with especially high corporate receipts are those with financial and petroleum industries (Mintz (2007)).

The Meade Report recommended a cash flow tax as the least distortive way to tax business profits. It is also an efficient withholding tax on rents accruing to non-residents, especially for the North Sea oil and gas developments, using the R-base, which has been adopted for royalty systems in some countries, as already mentioned. For the financial industry, the R-base is inadequate – instead, a more general treatment including financial flows is required.

To withhold rents from foreigners, an origin-base cash flow tax is necessary since earnings from exports are taxed (with a deduction provided for imports). A destination-base cash flow tax that exempts earnings from exports (and provides no deduction for imports) will not withhold rents earned from domestic production that accrues to foreign owners. Thus, an origin-base cash flow tax makes sense in minimizing inter-asset, inter-industry and inter-temporal distortions although firm location might be affected.

The Corporate Tax as a Surrogate User Fee

Governments provide public services – including infrastructure, municipal services, and even political stability (rule of law) – that are beneficial to businesses operating in the jurisdiction. As user fees may not be assessed or charged below cost, a business will obtain origin-base rents from the use of under-priced public services. Similar to the argument that a rent tax should apply to origin-base rents, both domestic and foreign-owned businesses should pay tax on the rents accruing from under-priced factors of production.

Clearly, compared to a user fee, the rent tax is inferior since it would be better to charge for the service so that businesses more appropriately compare marginal benefits and costs when using various inputs in production. When roads and bridges are provided free, for example, businesses could arrange their production further from markets to minimize costs by substituting distribution for production expenditures. However, not all public services are easily priced for administrative reasons and, politically, governments might wish to under-price some services anyway.

In absence of a perfect user fee system, an origin-base tax would be useful for this reason as well.

Conclusion

A practical case could be made perhaps for a general destination-base cash-flow tax (such as existing value-added taxes), as recommended by the authors, but it would have quite important implications for the personal tax system and the tax treatment of rents earned at source in a jurisdiction. Without the origin-base approach to a cash flow tax, individuals might look to shift their consumption and earnings to foreign jurisdictions, a problem, which at this point, is not as serious with migration limitations.

I suspect that countries will muddle through with their tax systems. If we moved to the full adoption of the Meade report, an origin-base tax should at least be considered for a variety of reasons to withhold rents. Given the latest robust corporate income tax collections among OECD countries, it is unlikely that a major shift will occur towards taxing businesses on the destination principle for tax policy considerations at least yet.

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