Executive Summary

This Report analyses fundamental reforms of corporate income tax systems in OECD countries. Fundamental corporate income tax reform goes beyond the ongoing marginal corporate tax reforms, which consist of rate reductions and corporate base broadening, and centres around four major policy concerns. These policy concerns are reflected by the following four questions: How can countries maintain their current levels of corporate tax revenue? How can countries maintain or create an attractive investment climate? How can countries reduce the (mainly financial) tax-induced distortions? And how can countries reduce the increasing tax complexity?

Chapter 1 of this Report presents the trends in the taxation of corporate income in OECD countries. The data shows that corporate tax rates have been declining during the last decades. Larger-sized OECD countries continue to levy corporate taxes at higher rates than the smaller-sized OECD member countries. However, despite the strong reduction in statutory corporate tax rates, corporate tax revenues have kept pace with – or even exceeded – the growth in GDP and the growth in revenues from other taxes in many OECD countries. This might partly have been caused by the broadening of corporate tax bases, for instance through the provision of less generous tax depreciation allowances. Corporate tax rates will probably continue to decrease in the near future. However, whether it will be possible to further compensate these rate reductions by additional base broadening measures remains to be seen.

The reasons for levying a corporate tax are reviewed in Chapter 2. The analysis indicates that no strong case can be made for the exemption from tax of the return on capital income – either the normal return or the economic rents – at the corporate or personal level. In fact, there are good reasons to tax capital income at the corporate level. The main reason for imposing a corporate tax is that the tax plays an important withholding function, acting as a “backstop” to the personal income tax. The corporate tax might be needed to avoid excessive income shifting between labour income and capital income. The corporate tax also acts as a withholding tax on equity income earned by non-resident shareholders, which might otherwise escape taxation in the source country. Moreover, governments might levy a corporate tax because firms earn location-specific rents and/or because capital is not perfectly mobile. The analysis in Chapter 2 also discusses different factors that might influence the “optimal” mix between source-based corporate income taxes and residence-based personal capital income taxes.

Governments can implement either a corporate income tax or a corporate cash-flow tax. The latter might be referred to as a consumption type of corporate tax. Chapter 3 reviews the fundamental differences between income-based and consumption-based taxation. It is demonstrated that the immediate deduction of the investment outlays from the corporate cash-flow tax base exempts the normal return from corporate tax. Only
economic rents are effectively taxed under a corporate cash-flow tax (tax expenditure method). This chapter also discusses the different tax accounting systems (accrual accounting, realisation accounting and cash-basis accounting), which are at the centre of the discussion on fundamental corporate income tax reform.

The main drivers of corporate income tax reform are discussed in Chapter 4. The analysis focuses on the tax-induced distortions under current corporate income tax systems from a domestic and international tax point of view. The corporate income tax is likely to distort the total amount of investment and the type of investment projects that are undertaken, the corporate sources of finance and uses of profits, the location of the corporate tax base, the choice of a business’s legal form and the tax might have an impact on corporate mergers and acquisitions. The chapter also reviews the impact of the corporate tax under the “new” view, the “traditional” view and the “new new” view.

The section on tax incidence concludes that capital as well as labour and consumption may partly bear the corporate tax. In addition to the Harberger model, the incidence of the corporate tax is discussed in an open-economy. It is argued that the easier it is to substitute foreign production for the home-country's production and the more mobile is capital, the lower is the burden of the corporate income tax on capital and the higher is the burden on the more immobile production factors such as labour. However, if capital is less substitutable (less internationally mobile), then the corporate tax burden will fall partly on capital.

Also tax revenue and tax complexity considerations are important drivers of corporate income tax reform. In addition to the sources of corporate tax complexity, the text presents the findings of the empirical literature that measures corporate tax compliance costs. Besides the international corporate income tax rules, corporations consider the accrual accounting rules, the capitalisation of assets and the sensitivity to timing to be the main sources of corporate income tax complexity and therefore of corporate compliance costs. Other important sources of tax complexity are the different tax treatment between debt and equity, the existence of different types of legal forms that are taxed differently, the tax rules with respect to business restructurings and the tax rules with respect to the transfers of business assets.

The main methods for integration of the corporate income tax and personal income taxes are introduced in Chapter 5. This chapter focuses especially on whether the integration systems realize tax-neutrality between debt and equity and between external and internal equity under a corporate income tax system.

Governments may tax corporate cash-flow instead of corporate income. Chapters 6 and 7 evaluate the corporate cash-flow tax respectively from a domestic and an international point of view. This Report discusses the different corporate cash-flow tax bases (the R-base, the R+F-base and the S-base) and analyses the implications with respect to efficiency, tax revenues and tax complexity of the introduction of a corporate cash-flow tax. The main advantages of a corporate cash-flow tax are in fact twofold. First, because the normal return on equity and interest payments are not effectively taxed at the corporate level, a corporate cash-flow tax does not distort the corporate choice between debt and equity and between internal and external equity. Second, the corporate cash-flow tax strongly reduces tax complexity because, for instance, assets no longer have to be capitalised and because the tax avoids many other complex timing-related problems. The Report also discusses the taxation of financial services and some transitional corporate cash-flow tax reform issues. Moreover, the text presents the impact of the corporate
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cash-flow tax under the “new” view, the “traditional” view and the “new new” view and presents the differences between a destination-based and an origin-based corporate cash-flow tax.

Some countries have introduced a (kind of) corporate cash-flow tax. These country experiences are reviewed in Chapter 8. The UK North Sea Fiscal Regime and the petroleum tax system in Norway are presented. Also the regional tax on business activities in Italy and the Estonian corporate cash-flow tax are discussed.

The alternative corporate income and corporate cash-flow tax systems are discussed in detail in Chapter 9. The analysis focuses on the impact of the reforms on efficiency, tax revenues and tax complexity, and on the transitional effects of these types of corporate tax reform. The following corporate tax systems are discussed: the full imputation tax system, the corporate allowance for corporate equity/capital tax system, the allowance for shareholder equity tax system, the shareholder allowance/credit for corporate equity tax system, the comprehensive business income tax system, the destination-based corporate cash-flow tax system and the origin-based corporate cash-flow tax system.

The full imputation tax system treats the corporation as a pass-through, providing full integration of the corporate tax on distributed and retained profits with the capital income taxes on the return on equity at the personal level. Under full imputation systems, the corporate tax is used merely as a prepayment of the tax on equity at the personal level. As a result, full imputation systems allow for neutrality between debt and equity in a closed-economy, but generally not in an economy where shares are held by foreign residents.

The corporate allowance for corporate equity (corporate ACE) tax system – as, for instance, implemented in Belgium – provides a deductible allowance for corporate equity in computing the corporation’s taxable profits. Similar to the deductibility of interest payments from the corporate income tax base, the allowance for corporate equity equals the product of shareholders’ funds (generally equals the company’s total equity capital) and an appropriate nominal interest rate. The allowance therefore approximates the corporation’s “normal” profits. The corporate tax is then confined to economic rents because only corporate profits in excess of the ACE are subject to corporate tax. As a result, the ACE tax system does not distort the choice between debt and equity as sources of finance at the corporate level.

The ACE tax system continues to have different tax rules for debt and equity (even though the debt-equity choice is no longer distorted at the corporate level). However, the allowance for corporate equity might be extended to corporate debt. Governments might allow corporations to deduct an allowance for corporate capital (ACC) from their taxable corporate earnings. The ACC would be calculated by imputing a return on the company’s total capital. The ACC would then replace the current interest deductibility. The ACC will have the same economic implications as the ACE but might further reduce complexity as the actual difference between debt and equity for tax purposes ceases to exist.

The allowance for shareholder equity (ASE) tax system – as implemented in Norway – exempts the normal return on equity from double taxation as well. However, it provides tax relief for the normal return on equity not at the corporate level as under the ACE tax system, but at the personal level instead. The corporate tax therefore continues to play its withholding function. The ASE might be calculated as the value of the shares held by the household multiplied by an imputed return as, for instance, the after-tax interest rate on
medium term government bonds. As is the case for the ACE tax system which is equivalent to a corporate cash-flow tax, the ASE tax is equivalent to a personal level cash-flow tax.

Under the shareholder allowance for corporate equity (shareholder ACE) tax system, the allowance for corporate equity would be calculated in a similar way as under the corporate ACE tax system. However, instead of deducting the ACE from the corporate tax base, the corporation would divide the ACE by the number of shares. Each share would receive its part of the ACE and shareholders would be entitled to deduct the shareholder allowance from their personal income tax base – not from taxable interest payments – at the personal level. Instead of providing an allowance per share, governments might provide a tax credit for each share equal to the ACE that is assigned to each share multiplied by the corporate tax rate. This tax system might then be referred to as the shareholder credit for corporate equity (shareholder CCE) tax system.

The comprehensive business income tax (CBIT) system implements neutrality in the debt-equity choice in a different way. The CBIT taxes the return to capital of corporations only once. Under the CBIT tax authorities allow no deduction of either interest payments – the tax might therefore be seen as a way to broaden the corporate tax base – or the return on equity from taxable corporate earnings. Except for the CBIT rate, no additional taxes would be imposed on distributions to equity holders or on payments of interest.

The destination-based corporate cash-flow tax is levied on domestic sales with a deduction for the purchases from domestic suppliers – including investment goods – and for labour costs. Export sales do not have to be included and imports are not deductible from the tax base. The destination-based corporate cash-flow tax is a tax on domestic (either domestically-owned or foreign-owned) capital income and domestically-owned foreign capital income, as far as this income is consumed in the domestic market, net of new domestic (either domestically-owned or foreign-owned) investment and domestically-owned foreign investment.

The origin-based corporate cash-flow tax is levied on domestic and foreign sales with a deduction for the purchases from domestic and foreign suppliers – including investment goods – and for labour costs. It is a tax on domestic and foreign-owned domestic capital income net of domestic and foreign investment in the domestic country. Examples of an origin-based corporate cash-flow tax are the Hall-Rabushka flat tax, the Bradford X-tax and Zodrow and Mc Lure’s two-tier progressive rate cash-flow tax.

The last part of the Report focuses on the main policy conclusions that can be drawn from this study. This section stresses that not only the type of corporate tax system but also the level of the corporate tax rate is a key factor for fundamental corporate tax reform to be successful.