Issues in the Design of Taxes on Corporate Profit

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Motivation

- **Mirielle review (2011) of the design of taxation**
  - Instituted by Institute for Fiscal Studies as successor to Meade Committee report (1978)
  - Chaired by Nobel Laureate, Sir James Mirrlees, with array of academic stars
  - Contained radical proposals for corporation tax based on earlier IFS Capital Taxes Group proposals (1991)

- Many governments cutting corporate taxes in effort to boost growth, despite deficits
  - Some (eg. UK) basically reducing rate
  - Others (eg. Italy, Australia) introducing similar allowance as proposed by Mirrlees
Outline

- Mirrlees review on taxes on corporate profit:
  - Proposed an allowance for corporate equity (ACE)
  - Similar in NPV terms to Meade’s (1978) flow of funds tax
- What are the proposals, and what are their characteristics?
- Are they the best way forward for national-level taxes on corporate profit?
Two broad questions

What should be taxed?
- The return to shareholders?
- The total return?
- Economic rent?

Where should it be taxed?
- Residence of shareholders?
- Residence of corporate headquarters?
- “Source” of profit?
- Where final product is consumed?
Meade/Mirrlees proposals

- What should be taxed?
  - Only economic rent

- Meade: flow of funds taxes
  - If all cash flows, positive and negative, are taxed at rate $t$, then NPV of tax = $t \times$ pre-tax NPV of project
  - Neutral in sense that pre-tax and post-tax NPV have same sign
  - R-base or R+F (or S) base
Meade/Mirrlees proposals

- Mirrlees: Allowance for Corporate Equity (ACE)
  - similar to interest deductibility
  - ACE allowance = rate of return * base
  - base = base last period + net new equity + taxable profit – tax – dividends
  - rate should reflect risk of ACE not being received
  - ACE offsets difference between depreciation rate and 100% allowance implied Meade; so same as Meade in NPV terms
Meade/Mirrlees proposals

- Where should it be taxed?
  - Meade doesn’t address this
  - Mirrlees does but makes no proposals as alternative to existing “source” basis
  - Mirrlees justifies tax on “source” basis by existence of location-specific economic rent
    - could be taxed without affecting investment
    - but need to tradeoff against imposing tax on other activities
Margins of corporate decision-making

Choice between mutually exclusive options

- Depends on effective average tax rate (EATR, i.e. proportion of NPV taken in tax)
- Examples:
  - Choice of legal form, type of investment
  - Location

Tax on economic rent

- No distortion within corporate sector in single country since EATR=t and equal for different opportunities
- But distorts eg. location choice between countries
Margins of corporate decision-making

Choice of scale of investment

- Undertake investment up to margin at which additional unit just breaks even
- Depends on effective marginal tax rate
- Traditional case studied by economists

Tax on economic rent

- Has zero tax on marginal investments: therefore neutral
Margins of corporate decision-making

Choice of form of income

- Depends on statutory rate at which alternative forms of (taxable) income are taxed

Examples:

- Small owner-managed business: take return as salary or profit?
- Multinational: shift profit to lower-taxed country?

Tax on economic rent

- Would need a higher statutory rate for revenue-neutral reform: so could induce more shifting
Margins of corporate decision-making

- **Choice of source of finance**
  - Depends on treatment of return to debt finance vs. return to equity finance
  - Is there any reason to treat them differently?

- **Tax on economic rent**
  - Gives relief for normal return to both sources of finance, so is neutral
  - Keeping interest deductibility with ACE implies tax on whole rent only if interest paid = marginal return
Properties of ACE

- Neutral in a closed economy
  - (if tax rate matches that on earned income)
- But not neutral on international decisions that depend on statutory rate
- Which decisions are more sensitive to tax?
- Which distortions give rise to greater social loss?
- Could other reforms improve welfare more?
Empirical assessment of ACE

- CGE Model of 27 EU countries + USA + Japan
  - Households choose labour supply and saving
  - Governments balance budgets
  - Companies use 3 factors: immobile labour, mobile capital (location depends on cost of capital), mobile fixed factor (e.g. brand; location depends on statutory rate)
  - Domestic and multinational in each country; multinational owns subs in each other country
  - Profit shifting possible
### Economic effects of unilateral introduction of ACE

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Debt v equity with an ACE

- Tax avoidance issue?
  - Outbound equity investment should reduce base for domestic ACE if return is not taxed
  - But return to outbound debt investment is taxed
  - Convertible debt?

- Broader issue
  - But why allow companies to choose where to pay tax?
  - Should treat debt and equity same at international level as well
More generally: Where is profit located?

RESIDENCE OF INDIVIDUAL
RESIDENCE OF HEAD OFFICE
SOURCE
DESTINATION
More radical options?

- Formula apportionment
  - CCCTB proposal of European Commission
  - May resolve profit shifting within area, but leaves all other distortions

- Tax in residence of shareholders?
  - Too difficult
More radical options?

- Tax in destination country?
  - As in VAT
  - Cash flow tax with border adjustment would tax economic rent on destination basis
  - Neutral on all margins if consumers are immobile
Verdict on ACE

- Improvement if introduced without increase in tax rate and if revenue can be raised from less-distorting tax

- But takes source basis (and rate) as given
  - If corporation tax more distortionary than eg. consumption taxes, why not reduce rate further?

- Time to consider more radical options