Issues in the Design of Taxes on Corporate Profit

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Motivation

- Mirrlees 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 * 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 <u>average</u> tax rate (EATR, ie. 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 <u>marginal</u> 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 <u>statutory</u> 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 <u>more</u> shifting

Margins of corporate decision-making

- Choice of source of finance
  - Depends on treatment of return to debt finance v 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 (eg. 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

	Lump-sum tax adjustment		
Corporation tax rate (%*Δ)*	-		
Corporate tax revenue (ex-ante) (% GDP)	-1.3		
Effective tax rate on consumption (ex-post) (%*Δ)*	-		
Debt share (*Δ*%*)*	-4.7		
Cost of capital (*Δ)*	-0.5		
Wage (%)	2.3		
Investment (%)	6.3		
Employment (%)	0.8		
GDP (%)	2.3		
Welfare (*Δ*% in GDP)	0.6		

Economic effects of unilateral introduction of ACE

	Lump-sum tax adjustment	Consumption tax adjustment	
Corporation tax rate (%*Δ)*	-	-	
Corporate tax revenue (ex-ante) (% GDP)	-1.3	-	
Effective tax rate on consumption (ex-post) (%*Δ)*	-	1.1	
Debt share (*Δ*%*)*	-4.7	-4.7	
Cost of capital (*Δ)*	-0.5	-0.5	
Wage (%)	2.3	2.3	
Investment (%)	6.3	5.9	
Employment (%)	0.8	0.4	
GDP (%)	2.3	1.9	
Welfare (*Δ*% in GDP)	0.6	0.4	

Economic effects of unilateral introduction of ACE

	Lump-sum tax adjustment	Consumption tax adjustment	Corporate tax rate adjustment
Corporation tax rate (%*Δ*)	-	-	17.0
Corporate tax revenue (ex-ante) (% GDP)	-1.3	-	-
Effective tax rate on consumption (ex-post) (%*Δ*)	-	1.1	-
Debt share (*Δ*%)	-4.7	-4.7	-3.3
Cost of capital (*Δ*)	-0.5	-0.5	-0.3
Wage (%)	2.3	2.3	0.6
Investment (%)	6.3	5.9	3.9
Employment (%)	0.8	0.4	0.2
GDP (%)	2.3	1.9	0.8
Welfare (*Δ*% in GDP)	0.6	0.4	-0.2

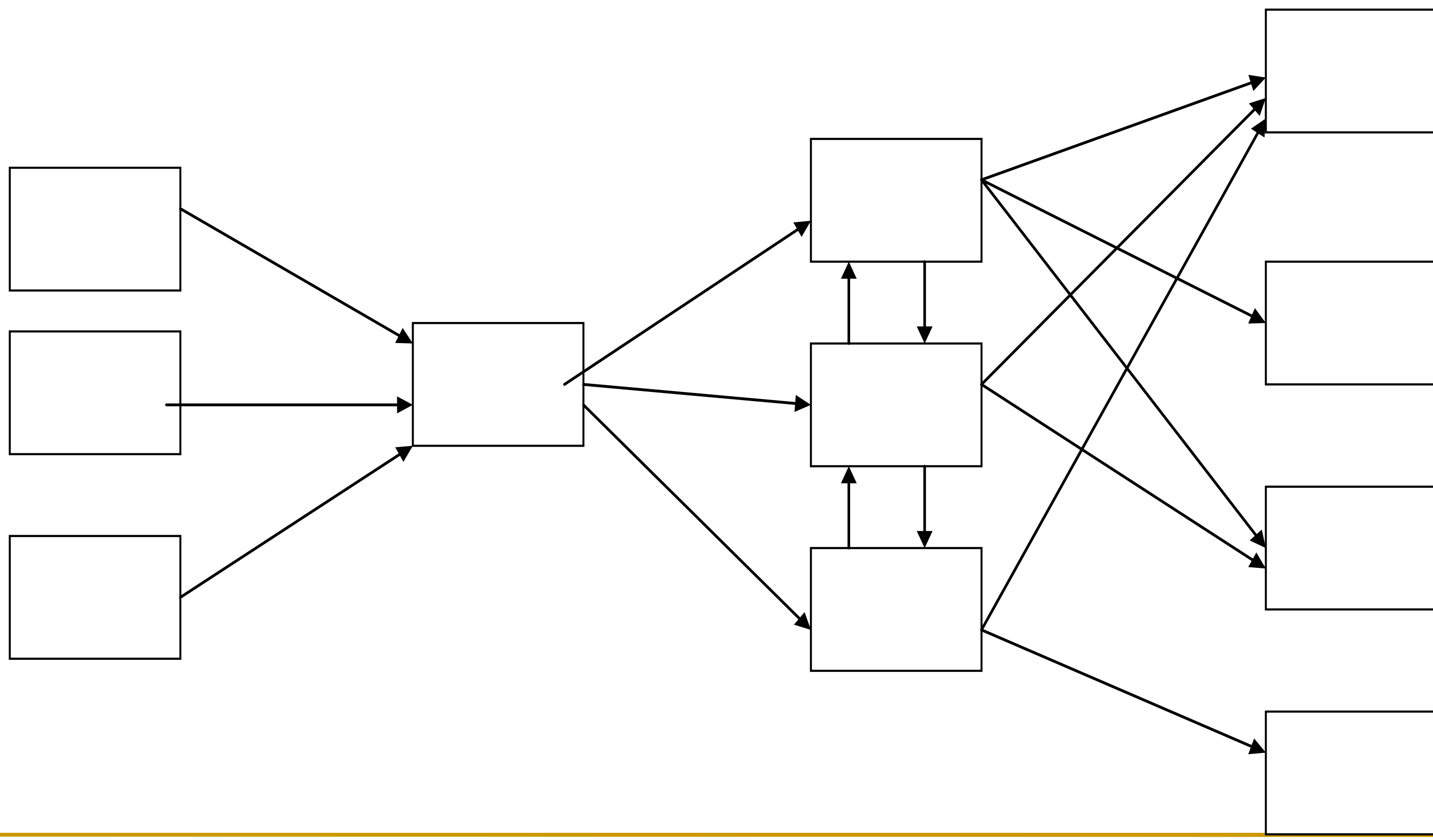
Debt v equity with an ACE

- 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 <u>if</u> introduced without increase in tax rate <u>and if</u> 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