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Preserving the Corporate Tax Base Through Tax Transparency

by Henry Ordower

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FEATURED PERSPECTIVES

Preserving the Corporate Tax Base Through Tax Transparency

by Henry Ordower

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This article is based on a paper presented at the 2013 Congress of the European Association of Tax Law Professors in Lisbon in May 2013, which will be included in *Corporate Income Tax Subject* (Amsterdam, forthcoming, Vol. 12 EATLP International Tax Series). The author would like to thank the attendees for their comments and strong criticisms of the article's proposal.

When, where, and at what rate to tax the income of business entities are the fundamental questions for the corporate income tax. Answers to those questions should remain independent of the taxpayer's choice of business form, because one may achieve identical revenue outcomes with entity opacity or transparency. When the answers to those questions vary with business form and tax system structure, opportunities to arbitrage those differences across national borders and diminish or avoid tax on the corporate income inevitably emerge.

Tax professionals, administrators, academics, economists, and business participants may and often do disagree on whether a corporation's (or other business entity's) income from the operation of its business should be taxable to the corporation itself or taxable to its owners. Opinions also may diverge on whether to tax investment income differently from income from the operation of a business. Despite those disagreements, as long as there is to be an income tax,[1] all will agree that the choice of one business form over another should not result in income from business operations escaping income tax completely.

Similarly, income should be subject to tax primarily where the taxpayer produces income from the operation of a business. Taxing income where the taxpayer's principal office or seat of management happens to be makes sense only under a system that taxes residents and citizens on their worldwide incomes (a global model of taxation like the United States has) and then only secondarily to the place of income production in order to prevent taxpayers from gaining an advantage by placing their income in low-tax jurisdictions.[2] Those jurisdictions that tax resident corporations on their worldwide incomes cede primary taxing authority to the jurisdiction where the taxpayer produces income.[3] Determining where the taxpayer produces income often

[1]Proposals to substitute a consumption tax for an income tax are common, and it is possible that in the future an income tax may no longer exist.

[2]Agreement as to location emerges fairly clearly from the common consolidated corporate tax base (CCCTB) proposal. *See* European Commission, Brussels, COM(2011) 121/4, 2011/0058 (CNS), Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (2011) at 14 (CCCTB proposal), *available at* http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf.

[3]For example, the U.S. allows a credit against the corporation's U.S. tax for the tax paid in the jurisdiction of production.

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is challenging because intellectual property may be in one location, factories in a second location, service employees in a third location, sales in a fourth, and all contribute to the production of the taxpayer's income.[4]

This article argues that a wholly transparent income tax system would improve existing corporate tax systems and establish tax neutrality between entities currently subject to the corporate income tax and those that are not. Full transparency is consistent with international treaty obligations and simultaneously eliminates many international tax arbitrage opportunities. Business needs rather than tax benefits would drive choice of business form. If accompanied by a robust system of international apportionment of business income,[5] a fully transparent corporate income tax would eliminate most income allocation arbitrage as well as tax system structure arbitrage opportunities.

Some History

No universal international standard for imposition of the corporate income tax exists. Two often converging lines of argument for an entity-level tax emerge:

- limited liability; and
- separate personality.

Internationally, limited liability is a key factor, and, consistent with that argument, several developed countries even impose a corporate income tax on limited partners' shares of limited partnership income but not on the general partners' shares. Developed countries tend to have one or more types of tax transparent entities, including something comparable to a general partnership.

The concepts of separate personality and limited liability led many jurisdictions to tax corporations at rates consistent with individual income tax rates. When the corporations distributed their earnings to their owners, the owners would include the distributions as dividends in their individual incomes subject to the owners' individual income tax rates. Separation of the entity from its owners for tax purposes caused the aggregate tax on corporate earnings to combine the two levels of tax. If, for example, the maximum income tax rate for all taxpayers was 50 percent, the total tax on distributed corporate earnings would be 75 percent — that is, 50 percent at corporate level and 50 percent of the remaining 50 percent (after corporate tax) at shareholder level. This full two-level tax is less common today than it was several decades ago.

In the 1940s, objections to the full two levels of tax began to emerge. Objectors sought with some success to characterize the corporate tax system as unjustifiable double taxation. Despite the corporation's separate personality, it seemed indisputable that the corporate owners economically bore the corporate tax in addition to the shareholder tax so that integration of corporate and shareholder taxes on corporate earnings became compelling. Increasingly, however, economic models identify a shift of the incidence of some or all the corporate tax to labor through lower wages and consumers through higher prices. Even the staunchest proponents of full separate taxes concede that relief from multiple impositions of the corporate-level tax through chains of corporations is desirable. Consolidated returns of income for groups of related corporations and dividend relief for distributions from corporations to corporate owners of their shares have become common.

More recently some countries (with the United States in the lead) began to de-link the concepts of separate personality and limited liability. Limited liability ceased to be determinative of tax opacity. Rather, public trading of ownership interests signaled separateness of personality, so that public companies remained opaque while many closely held businesses became tax transparent (or the owners could elect transparency for the company).

Increasing economic globalization and aggressive tax planning exert continuous downward pressure on corporate income tax rates. Capital mobility creates the perception that business owners will shift their corporate income to jurisdictions with favorable corporate tax systems unless the home jurisdiction decreases rates. To remain competitive, nations have adopted a variety of strategies to combat loss of tax revenue to lower tax jurisdictions. Many countries have reduced the corporate rate from individual rate levels to corporate rates that are half or less than half of maximum individual rates. Others have adopted systems of low rates for businesses with the greatest mobility while retaining higher rates for businesses requiring large infrastructure investments. Some countries even have reduced the corporate rate to zero and increased individual rates or shifted the tax burden to consumption taxes (like the VAT) to offset lost corporate revenues.

Reducing corporate rates would make tax policy sense without jeopardizing tax collection if the individual-level tax would follow closely on the corporate-level tax. Corporations always have had the opportunity to defer the individual-level taxes by retaining earnings rather than distributing dividends. Often

[4]The CCCTB proposal addresses the location problem through formulary apportionment of business income.

[5]*See* CCCTB proposal. For discussions of worldwide formulary apportionment, see Julie Roin, ''Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment,'' 61 *Tax L. Rev.* 169 (2008); Reuven S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, ''Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split,'' 9 *Fla. Tax. Rev.* 497 (2009); Susan C. Morse, ''Revisiting Formulary Apportionment,'' 29 *Va. Tax. Rev.* 593 (2010); Henry Ordower, ''Utopian Visions Toward a Grand Unified Global Income Tax,'' 14 *Fla. Tax Rev.* (forthcoming 2013), Saint Louis U. Legal Studies Research Paper 2012-32, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2182866.

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shareholders can convert the deferred income into capital gain taxed at preferred rates of tax in many jurisdictions. Corporate income frequently becomes subject to combined corporate and individual rates significantly lower than the individual rate on business income. In those instances, corporate operating form has a tax advantage over noncorporate operating form that is difficult to justify.

Corporate-Shareholder Integration

Whether the theoretical underpinnings for two-level taxes on corporate earnings are sound or not, two-level tax structures have become obsolete. Continuing to impose a high corporate rate may drive businesses to lower-tax jurisdictions. Even if high rates do not motivate choice of business location on any significant scale, political rhetoric has done much to persuade the public that the corporate rate is too high — out of line with competitive corporate rates. Political assertions similarly may persuade the public that double taxation of corporate earnings is unjust, impractical, and uncompetitive even if untrue. Substitution of a single-level income tax on corporate earnings may become necessary to protect the corporate income tax as a revenue source and may be more efficient in the current political climate than a two-level tax.

Proposals to integrate corporate and shareholder taxes have taken at least four forms:

- corporate deduction for dividends paid to make the selection of debt or equity capital tax neutral;
- imputation systems providing a shareholder credit for the corporate tax (advance corporate tax);
- reduced or zero tax rate on shareholders' receipt of dividends through an exclusion of the amount of dividends the taxpayer receives or a deduction for all or part of those dividend amounts; or
- tax transparency of the entity.

Each integration method is imperfect, but the full transparency model with collection of tax at entity level, despite its complexity, seems least likely to encounter legal barriers in the European Union and possibly other regions.

Deductibility of dividends establishes neutrality between debt capital and equity capital. The current distinction between deductible interest and nondeductible dividends has long generated a bias toward debt financing. There are, however, real risk differences and burdens that distinguish debt from equity. Entities must meet their debt obligations, so that the obligation to pay interest burdens the entity and limits the entity's free use of its debt capital. Debt also enjoys a general priority over equity capital on termination of the entity's life, but debt generally does not participate in the entity's growth. Those distinctions between debt and equity reflect themselves in accounting rules and entity valuation. While debt and equity have differing positions on an ownership continuum so that as one changes the characteristics of the specific debt issue, it comes to resemble equity ever more and vice versa. Yet historical tax differences between debt and equity may prove difficult to overcome.

Probably more important is current double tax treaty practice, which tends to shift the location of income from the producing country to the investing country. The common practice of reducing the withholding rate on cross-border payments of interest and dividends often results in deductible payments reducing the tax in the jurisdiction of the entity's operation and shifting the inclusion to the country where the capital provider is located. Sometimes that dividend and interest income does not incur a tax in any jurisdiction. Deductibility of dividends also would exacerbate the existing problem of deductible payments to tax-exempt organizations that currently allow much corporate operating income to escape tax through the deduction.

The imputation system for integration was popular in Europe until the European Court of Justice held that the shareholder's residence jurisdiction had to grant a credit for taxes paid by a foreign corporation that distributed a dividend to a resident shareholder even though the resident jurisdiction received no part of the corporate tax paid.[6] Because imputation systems used a credit for corporate taxes paid, those systems avoided the problem of tax-exempt shareholders that had no tax against which to claim the credit.

Few jurisdictions continue to impose both corporate- and shareholder-level taxes without rate concessions relative to other sources of income. Many jurisdictions impose a lower rate on corporate dividends and gain from the sale of corporate shares than on other types of income, so that there is partial integration in the form of a full corporate-level tax followed by a reduced shareholder-level tax. Other jurisdictions have reduced both the corporate-level tax and the shareholder-level tax to balance the sum of the two to be more or less the same together as one full single-level tax.

Assume that Jurisdiction X considers 50 percent to be the ideal tax rate for all income. It could impose a 50 percent tax on entity-level income for all entities and allow those entities to distribute their profits freely and without further tax to their owners. This is a simple solution. The entity bears the tax burden and pays the tax when and where it earns the income. The recommendation in this commentary adopts a variant on this structure.

The combined forces of international tax competition and capital mobility, however, make it necessary to reduce the entity-level tax in order to prevent capital

[6] *Petri Manninen* (C-319/02), [2004] ECR I-7477, *available at* http://curia.europa.eu/juris/showPdf.jsf?text=&docid=49454&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=622015.

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flight to lower-tax jurisdictions. Assume that international competitive norm limits the entity rate to 25 percent. The owner-level tax must increase to 33.3 percent to capture the aggregate ideal 50 percent tax.[7] While the possibility of reaching the ideal tax inheres, the outcome is less desirable and certain. The method defers the owner-level tax until the entity distributes its income. Part of the tax may elude Jurisdiction X if some of its owners are not subject to tax in the jurisdiction because they are exempt from tax or are nonresident. For nonresidents, a 33.3 percent withholding tax on entity distributions might gain the tax revenue but current treaty practice precludes such a high withholding tax on distributions.

Tax transparency offers the most efficient and palatable solution to the one-level tax rate conundrum by locating and taxing income where the taxpayer produces it without violating treaty obligations. This proposal is discussed in the next section.

Recommendation

Tax transparency forestalls tax competition by setting the nominal corporate income tax rate at zero as imputation systems effectively did. The corporation acts in a manner analogous to a withholding agent for its owners by paying the maximum shareholder tax on the entity's income on behalf of its shareholders when and where the entity earns the income. Regardless of their countries of residence, shareholders would include in their individual incomes their shares of the entity's income as if they received the income directly from the source, in the manner, and at the time the corporation received the income.[8]

Under a full transparency system, each underlying shareholder (through layers of corporations, if necessary) would be engaged in the corporation's business in the taxing jurisdiction but only to the extent of the shareholder's portion of the corporation's income. Unlike imputation systems, the shareholder would not receive a dividend from the corporation the tax on which the shareholder could offset with the corporate tax paid. The shareholder would be primarily liable for the tax on corporate income and receive a credit for the entity-level payment (or withholding) from the taxing jurisdiction against his individual income tax payable in the jurisdiction where the corporation earned the income.

Nonresident shareholders would not have to file an income tax return in the taxing jurisdiction but would receive no withholding credit if they did not file. Shareholders could file a return of income in the taxing jurisdiction on their shares of the corporation's income in that jurisdiction and receive a credit for the entity tax payment against the tax determined on that return. To ensure collection of a tax on all operating income of the corporation, tax-exempt shareholders would be taxable on their shares of the corporation's operating income even if the shareholders are exempt from tax on income from other sources.

This transparency system should not run afoul of the imputation decisions of the ECJ[9] because it treats all shareholders equally, regardless of residence, by imputing the entity's business and location to all owners. Losses may prove more of a challenge. If the entity incurs a loss, the system would have to limit the deductibility of the loss for both resident and nonresident owners to income from that entity's business in the taxing jurisdiction, a carryover system, to remain permissible under ECJ case law.

Under this transparency recommendation, liquidity is not a problem as it is for many minority owners of existing transparent entities. In existing transparent entities, minority owners sometimes must depend on the cooperation, and even beneficence, of the controlling owners to distribute enough cash to enable the minority owners to pay tax on their shares of the entities' incomes. Under this recommendation, the entity pays the tax for its owners, who may or may not claim the credit. Troubling for some taxpayers, however, may be the disclosure of beneficial ownership necessary to tax the underlying owners on their shares of the corporation's income — a secrecy concern. Compulsory disclosure of beneficial ownership is a growing international trend, as jurisdictions seek to prevent their taxpayers from hiding investments outside their home jurisdictions.

Nevertheless, owners concerned about ownership secrecy could choose not to include the income from the corporation and, in the case of a corporation in another jurisdiction, not file a return in that jurisdiction. Since the corporation has ''withheld'' at the highest individual rate, the jurisdiction in which the corporation earns its income loses no tax revenue.[10]

In the presence of widely dispersed ownership interests, active trading of interests, and frequent presence of indirect ownership, transparency becomes complicated. Allocating entity income among an ever-changing pool of shareholders requires adoption of various income accrual conventions such as allocation of all annual income evenly on an hourly or daily ownership basis. Computer technology should be equal to a

[7] That is 25 percent of income, plus one-third of the remaining 75 percent of the entity's income.

[8] Compare section 702(b) of the Internal Revenue Code of the United States (1986) (imputing the source and character of a partnership's income to its partners).

[9] *See Petri Manninen* (C-319/02).

[10] Ultimately, secrecy of beneficial ownership is likely to yield to the needs of administering a global income tax. *See supra* note 5.

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challenge of this computational complexity — technology already manages allocations in the gargantuan mutual fund industry.

Preference for debt financing will worsen under a full transparency system unless the shift to transparency carries debt along and treats debt holders as it does shareholders. Alternatively, the tax system could recharacterize the ownership of debt as doing business where the debtor uses the borrowed funds. Or the corporate operating jurisdiction could impose withholding tax at the source on interest paid equal to the individual rate of tax and not allow treaty reductions in that rate.

Continuing Capital Flight

Full transparency does not eliminate the problem of capital flight. The CCCTB proposal[11] may diminish the capital competition problem within the European Union insofar as shifting the place of the corporation's management will not necessarily shift its income. However, the CCCTB proposal may be only a first step in development of a worldwide system to apportion business income (or all income) and permit jurisdictions to set rates rationally without concern of capital flight.[12]◆

[11] *See supra* note 2.

[12] *See supra* note 5.

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