eJournal of Tax Research

Volume 5, Number 1 July 2007

CONTENTS

5 Fiscal Misperceptions Associated with Tax Expenditure Spending: the Case of Pronatalist Tax Incentives in Singapore
Poh Eng Hin

40 What Future for the Corporate Tax in the New Century?
Richard S. Simmons

59 Charities for the Benefit of Employees: Why Trusts for the Benefit of Employees Fail the Public Benefit Test
Fiona Martin

71 Responsive Regulation and the Uncertainty of Tax Law – Time to Reconsider the Commissioner's Model of Cooperative Compliance?
Mark Burton

105 Unravelling the Mysteries of the Oracle: Using the Delphi Methodology to Inform the Personal Tax Reform Debate in Australia
Chris Evans

135 The Marginal Cost of Public Funds for Excise Taxes in Thailand
Worawan Chandoevwit and Bev Dahlby

atax
UNSW
Faculty of L...

© Atax, The University of New South Wales
ISSN 1448-2398

broader issue of how the structure of individual countries' tax systems, and of the international tax system, might evolve in future.

The paper is divided into five further sections. The next section considers recent criticisms of the tax, and why these have become more pronounced in recent years. The paper then discusses why, in spite of these complaints, the tax remains widely in use. It does this by analysing the more conventional justifications put forward for its existence and then considering further explanations for its durability. The future of the tax is then considered, while a final section concludes.

THE CORPORATE TAX UNDER ATTACK

Recent economic, political and technological developments have provoked renewed criticisms of the corporate tax. These criticisms are now outlined in turn.

Allocational Issues Across Jurisdictional Boundaries

When companies operate in more than one taxing jurisdiction, the question is raised of how to allocate the profits raised between those jurisdictions. In particular, policies and practices need to be established on how to charge transfers of physical goods, services and intangible property between business units within a multinational group (transfer pricing). Over time, an international consensus has been built up, establishing the "arm's-length principle" for transfer pricing, i.e. that intra-group transactions should be priced as though they were being transacted by independent persons. This international consensus culminated in the OECD Transfer Pricing 21604ar34t812

Problems Posed by Electronic Commerce

Electronic commerce compounds the problem of income allocation mentioned above. E-commerce enables MNEs to further integrate their operations, making it difficult for tax authorities to identify and measure contributions to profit and allocate them to different jurisdictions. This problem is augmented by the often unique features of electronic contributions to profit, which make it difficult to determine their economic value.

Further, as mentioned by Warren (2002), the growth of the Internet and of secure global company-based intranets has enabled companies to shift profits more easily from one tax jurisdiction to another to avoid tax. The lack of a secure and verifiable audit trail makes it difficult for tax authorities to identify transactions and trace where they take place, expanding the scope for both tax avoidance and evasion.

The advent of e-commerce creates an even more fundamental problem for the administrators of the corporate tax. Commonly, companies that are held to be resident in a country are taxed on their worldwide income. Non-resident corporations are normally subject to tax in that country only if their operations constitute a "permanent establishment" there, and then only on domestically-sourced income. Thus the concepts of residence, permanent establishment, and the source of income are essential in the assessment of income to tax. However, with the borderless technology of the Internet significantly reducing the relevance of geographical considerations, the above concepts have become increasingly obsolete (indeed, the advent of e-commerce puts the entire traditional concept of jurisdiction to tax into question). In particular, there is a growing need for a new international consensus on the definition of a permanent establishment, although some headway has been made on this by the OECD.[3]

A final problem that electronic commerce creates for the corporate tax concerns the characterisation of income. A further international consensus has been built in that the nature of the income in question determines the extent and form of the tax applied to it. In particular, royalty income is commonly taxed through withholding taxes in the source country when the payment is made to the non-resident. Sales income, on the other hand, is normally taxed as profits in the country where the seller is resident or has a permanent establishment (see Ho et al., 2004). Electronic commerce blurs the already hazy distinction between these two types of income. For example, if a digital product is purchased over the Internet, does the consideration involved constitute income from sales or is it a royalty from the right to use or for the use of the product's copyright? The difficulties involved in providing a definitive answer to this question allow considerable opportunity for tax avoidance.[4]

Distortions to the Optimum Global Allocation of Resources

The tax systems of individual countries, almost without exception, have developed primarily to address domestic concerns, such as the redistribution of income and

---

3

wealth, the macro-economic stabilisation of the economy, and the allocation of productive resources within the economy. Like any tax, the level at which the corporate tax is imposed in a country is therefore a reflection of the political, economic and social realities of that nation. Thus, as corporate taxes were introduced throughout the world, tax differentials between countries inevitably materialised. Although individual countries' tax systems have always affected and been affected by other economies, policy makers usually paid little attention to international tax differentials, as their effects were comparatively insignificant. Now, with the removal of non-tax barriers to investment and the integration of national economies, and the resultant increase in the mobility of international capital, corporate tax differentials are much more consequential, as they have an increasingly important role in determining

over the period 1982 to 2003, Simmons (2006) showed that the dispersion of statutory corporate tax rates fell by approximately one-third, while similar results were recorded for effective tax rates.

Nevertheless, recent evidence on effective tax rates (Baker and McKenzie, 2001; European Commission, 2001) suggests that international tax differentials currently remain high and represent a strong incentive for companies to choose the most tax-favoured locations for their investments. If tax competition is reducing distortions to investment, it clearly still has some way to go. Also, there are conceptual problems on relying on tax competition to reduce distortions to investment. As Musgrave and Musgrave (1990) argue, there is no clear theoretical backing for the supposition that tax competition will eventually result in a more efficient allocation of resources through reducing tax differentials. An equally likely scenario is that tax competition will foster a climate in which countries aim to attract capital through being tax-efficient rather than being least-cost locations, leading to greater rather than less distortion.

Distortions to Corporate Capital Structure

The corporate tax has long been criticised in that it favours one kind of finance (interest-paying debt) over another (shareholders' equity), since debt interest is usually deductible in the calculation of taxable profits, whereas dividends are normally not.[8] The separate tax treatment of debt and equity capital creates a tax-induced distortion to the optimum capital structure of corporations, since the tax confers a benefit onto the raising of funds through debt. This distortion also raises corporate risk, as it increases the chances of excessive gearing and bankruptcy.[9]

More recently, the distinction in the treatment of debt and equity has resulted in artificial investment forms that can be classified as debt but have the desired characteristics of equity (Cooper and Gordon, 1995). The difficulties that this situation has created have in recent years been exacerbated by the development of derivatives and other financial instruments that make the distinction between debt and equity much less clear than in the past. As Alworth (1998, p.512) explains:

> "The tax systems of most countries are wont to subdividing transactions into particular categories which are then subject to specific provision… Since

The Corporate Tax and Equity

There are two issues involved with regard to the fairness of the corporate tax. The first of these concerns the effective incidence of the tax, the second the problem of international double taxation.

The first issue rests upon the perception that a company per se cannot bear tax: only individuals can do so. Tax on corporate profits will thus ultimately be borne by the individual stakeholders in the company. Customers may bear the tax through an increase in the prices they are charged, the extent of the increase depending upon the degree of imperfection in competitive conditions. Employees may bear the tax through a reduction in their remuneration or an increase in unemployment, depending on the degree of imperfection in the labour market. Suppliers of capital may suffer the tax due to a reduction in the returns they are willing to accept. However, in a completely open economy, suppliers of capital will require the “world rate of return” or they will invest their money elsewhere. In this scenario, the corporate tax cannot reduce investors’ returns below that world rate, but can only lead to a decrease in the ad to a-8.7(w)a5fopenphe ca(a)-5(r).6 4(h)-1 Bo-6.9(p)4.e co3p

of these systems. A fully neutral treatment of investment income requires that countries not discriminate between domestic and foreign shareholders by denying to the latter the tax credit that the imputation system provides. Nonetheless, in practice there is a natural strong reluctance to grant foreign shareholders the tax credit, as it would have to be given by a different tax authority from the one levying the corporate tax. Thus imputation systems disfavour the foreign ownership of share capital. In times when the ownership of corporations was mostly domestic, this aspect of imputation did not constitute a major problem. Now, with the diffusion of share ownership throughout the world, the inequity of this situation is more apparent. In the EU, the European Court of Justice has recently ruled this aspect of imputation incompatible with single market freedoms.[10] This has recently resulted in many countries, such as the UK, moving away from imputation, generally towards some form of shareholder relief system. Some countries, for example Ireland, have reverted to the classical system, with its attendant double taxation implications for shareholders in those countries.

As the above analysis suggests, recent economic and technological developments have transpired to accentuate and draw attention to the inherent weaknesses of the corporate tax. In light of this, it is useful to review the justifications that have been traditionally put forward for the tax. These are identified and critically analysed in the following section.

EMERGENCE OF AND CONVENTIONAL JUSTICFICATIONS FOR THE CORPORATE TAX

The first taxes specifically on corporate income were introduced by individual states of the US in the mid-19th century. A federal tax on corporate profits was introduced in the US in 1909. In the UK, incomes, including the profits of societies and corporate entities, were first taxed under the Income Tax Act of 1799. Excess Profits Duty was introduced in 1915, representing an additional tax on company profits to that already imposed upon individuals' income from capital. This duty was replaced in 1920 by Corporation Profits Tax.[11] In the early years of the 20th century, many countries began a process of moving away from their tr

TABLE TWO: COPORATE TAXES: STATUTORY[1] AND EFFECTIVE MARGINAL TAX RATES (EMTRS)[2]: OECD SELECTED COUNTRIES (TEN YEAR INTERVALS, 1983-2003)

	Statutory Rates			EMTRs		
	1983 %	1993 %	2003 %	1983 %	1993 %	2003 %
Australia	50	33	30	32	21	24
Belgium	45	39	34	31	26	22
Canada	44	35	36	16	25	25
France	50	33	35	26	18	22
Germany	63	58	40	43	38	30
Japan	55	51	41	42	38	29
Portugal	55	40	33	48	24	19
USA	50	39	39	22	24	24
OECD 19 (mean)	48	36	33	28	23	20

Notes:

1) Statutory rates are on undistributed profits. For individual countries where the tax rate depends on the type of industry, the manufacturing rate is used. The rate includes local taxes (or average across regions) where they exist. Supplementary taxes are included only if they apply generally.
2) EMTRs calculated on the following assumptions: investment is in plant and machinery, financed by equity or retained earnings; depreciation at 12.5%; common inflation rate of 3.5%; real interest rate at 10%; no personal taxes.

Source: IFS

At one stage, it seemed that corporate tax competition might be curbed through the development of international initiatives aimed

upon whether tax rates still currently dwell on the inverse portion of the curve. Lower tax rates might also increase tax revenues by reducing the incentive for international tax avoidance and evasion, although increased opportunities for such activities are likely to mitigate against this.

There is, nonetheless, a possibility that tax competition may reduce corporate tax revenues to a level at which the economic costs of compliance and enforcement outweigh the benefits of retaining the tax, leading to government reconsideration of its viability. However, there is likely to be strong support, at least in some countries, for at least some level of corporate taxation. As mentioned earlier, the tax enables host governments to take a share of the profits

In spite of these challenges, the corporate tax is likely to survive in some form, at least for the foreseeable future. Today it represents a long-established, significant and welcome source of revenue for governments. It can be collected from an easily identifiable source, and is widely seen as justified by the general public. As the IFS Capital Taxes Group (1991, p.9) succinctly put it:

> "Perhaps the most persuasive reason for retaining a separate tax on profits is not only that we do, but that we can."

Worldwide abolition is not possible in the foreseeable future as it would require international tax co-ordination on a scale that has not been in evidence to date. A more likely scenario is that a major economy such as the US would take the lead in abolishing the tax, in which case smaller countries would have a strong incentive (or

Doernberg, R. and L. Hinnekens (1999), *Electronic Commerce and International Taxation*, Kluwer Law International, The Hague.

Eden, L. (1998), *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation*, University of Toronto Press, Toronto.

European Commission (1997), *Towards Tax Co-ordination in the European Union: A Package to Tackle Harmful Tax Competition*, COM(97), 495 final.

European Commission (2001), *Company Taxation in the Internal Market (Executive Summary)*, SEC (2001), 1681.

Gammie, M. (2001), "Corporate Taxation in Europe: Paths to a Solution", *British Tax Review*, 4: 233-249.

Gordon, R.H. and J. MacKie-Mason (1995), "The Importance of Income Shifting to the Design and Analysis of Tax Policy", in M. Feldstein, J.R. Hines, and R.G. Hubbard (eds.), *Taxing Multinational Corporations*, University of Chicago Press, Chicago.

Harris, P.A. (1996), *Corporate/Shareholder Income Taxation and Allocating Taxing Rights between Countries*, IBFD, Amsterdam.

Ho, D., A. Mak and B. Wong (2004), "Taxation of E-commerce in a Source-based Jurisdiction: A Study of Hong Kong", *Journal of Business Law*, March: 247-261.

IFS Capital Taxes Group (1991), *Equity for Companies: A Corporation Tax for the 1990s*, IFS Commentary No.26, IFS, London.

James, S. (2000), "The Difficulties of Achieving Tax Harmonisation: The Case of the European Union", *Asia-Pacific Journal of Taxation*, 4(4): 42-52.

James, S. and C. Nobes (2003), *The Economics of Taxation: Principles, Policy and Practice* (7th ed.), Financial Times Prentice Hall, Harlow.

Kay, J. and M. King (1991), *The British Tax System*, Oxford University Press, Oxford.

Keen, M. (2001), "Preferential Tax Regimes Can Make Tax Competition Less Harmful", *National Tax Journal*, 4(4): 757-763.

Krever, R. (1985), "Companies, Shareholders and Tax Reform", *Taxation in Australia*, 10(3): 163-175.

Lee, D.R. and R.B. McKenzie (1989), "The International Political Economy of Declining Tax Rates", *National Tax Journal*, 41(1): 79-83.

Mead, J.E. (1978), *The Structure and Reform of Corporate Taxation*, Allen and Unwin, Boston, MA.

Musgrave, P.B. and R.A. Musgrave (1989), *Public Finance in Theory and Practice*, McGraw-Hill, New York.

Musgrave, P.B. and R.A. Musgrave (1990), "Fiscal Co-ordination and Competition in an International Setting", in *Proceedings of the 8th Munich Symposium on International Taxation*, Kluwer Academic Publishers, Deventer.

Oates, L. (2002), "Taxing Companies and their Shareholders: Design Issues", in A. Lymer and J. Hasseldine (eds.),