Thematic Report: Tax neutrality between CIT and non-CIT subjects: how to improve our systems?

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1. Introduction

The primary purpose of taxes is to raise the money to finance government spending. In the opinion of many economists, it is a goal as such to raise the tax revenue without distorting the decisions that individuals and firms would otherwise make for purely economic reasons. Taxing businesses differently as to the (legal) nature of the person, who is the owner of the business, is a breach of the claim for a neutral tax system. The interference of taxes in the choice of the proper legal form for running a business causes unneeded costs for the taxpayers and finally reduces the overall tax revenue.

In the opinion of tax lawyers, taxes which are not neutral could infringe the principle of equality, but usually – like in case of taxing partnerships and companies differently – reasons can be found the justify the different tax treatment.

2. Trends in Corporate Income Taxation since the 1950ies

Since the 1950ies tree trends in taxing companies can be observed

1. After World War II in many European countries CIT rates (often progressive rates) were raised to an extent equal to income tax rates for income of individuals. Corporations had to contribute to the enormous demand of the states for tax revenues needed to reconstruct the infrastructure damaged during the war. Due to the high CIT rates, the problem of economic double taxation of corporate profits more and more moved into the awareness of tax legislators.

2. In the late 1970ies most European countries started to introduce measures to reduce or even eliminate economic double taxation of corporate profits. I want to remind you of the sophisticated imputation systems as used in Germany and Italy, which about ten years ago were abolished due to the requirement of the ECJ to give a credit for foreign CIT. Furthermore we have to take all different kind of tax release systems into consideration, which are nowadays commonly used to reduce economic double taxation.

3. The third trend in corporate income taxation, which can be observed during maybe the last 20 years, is the decline of the CIT rates. Nowadays a 25 % plus/minus flat CIT rate is commonly used within Europe. As a result, the marginal tax burden of distributed corporate profits might be lower than the marginal income tax rate.[1] Additionally, since dividends are in most countries taxed at the moment, when distributed, retained corporate profits, which are at the time of accrual only subject to CIT, are treated preferentially in comparison to business profits of a person subject to IIT.

[1] This is the case e.g. in Austria (marginal IIT rate 50 %, cumulated tax on dividends: 43,75 %), …..

3. Trends in the use of legal forms which provide for limited liability for running a business

Businesses are more and more often run in the legal form of a company. Owners of a business become more and more risk-averse and seek limited liability. If for tax purposes it seems to be appropriate to use a legal form which is taxed transparently, hybrid forms like limited partnerships with a company as only fully liable partner (GmbH & Co KG) are used. The reasons for this trend can be located within the company law as well as the tax law. During the last 20 years it became cheaper and cheaper to form a company. Minimum capital requirements for forming a company are not decisive any more for the decision over the proper legal form of a business.[2] The costs of economic double taxation of corporate profits, which in former times were regarded as kind of compensation for having limited liability, are in many European countries of no more relevance. As long as the national bankruptcy laws does not provide for regulations for an instant debt write-off for individuals, it is advantageous for everyone to make use of a legal form with limited liability for running a business.

4. System of a uniform business tax

4.1. Definition

As (uniform) business tax a tax should be understood which is levied on business profits at the time of accrual regardless of the legal form of the owner of the business. Under a system of a uniform business tax, business profits of individuals, partnerships and corporate entities are taxed in the same way. The tax is calculated regardless of personal circumstances of the owner of the business (in case of an individual being the owner of the business).

In addition to the business tax on retained profits, profit distributions and profit withdrawals are at time of payment at the owner´s level subject to income tax. This tax should be collected at source (withholding tax). Business tax and tax on profit distributions (withdrawals) lead to double taxation of business profits. It is necessary to eliminate or at least reduce such double taxation, but the way how to do it, is free to any State which have chosen to introduce the uniform business tax.

A uniform business tax is defined through tax neutrality with respect to the person who is the owner of the business. The definition of the uniform business tax does not stipulate for a certain tax rate structure. The tax rate could be flat as well as progressive. The marginal tax rate of the business tax could conform to the marginal rate of IIC or of CIT. In my proposal of a uniform business tax, which I will submit later on, I will argue for a flat rate, which is significantly lower than IIT rate.

4.2. History

The proposal of a business tax is not new. There was an extensive discussion about a business tax in Germany at the End of the 1940s and the beginning of the 1950s.[3] In Austria this topic was discussed

[2] The average minimum capital requirements for private companies with limited liability within the EU amounts to € 8.000,-. In Austria in 2013 the minimum capital requirements for private companies with limited liability were reduced from € 35.000,- to € 10.000,-.
[3] See Heidinger, Betriebssteuer und vollsynthetische Einkommensteuer, Wien 1983, 53 et seq.

30 years later but never became really ready for a decision. Since then a lot has changed like I have shown above: CIT rates are usually flat and significantly lower than ITT rates. In many countries, especially South-East European Countries[4], (limited) partnerships are taxed opaque like companies. In Hungary even individual entrepreneurs, if registered with the companies register as an individual company, are subject to CIT.

5. Proposal of a uniform business tax

5.1. Basic Points

a) Business profits, regardless of the person, who is running the business, shall be subject to a business tax, provided the profit is calculated under double entry book-keeping.
b) The tax rate of the business tax should be flat and should amount to 20 – 30 %.
c) Profit distributions and profit withdrawals are subject to a withholding tax amounting to 20 – 30 %.
d) Domestic owner(s) of the business/domestic shareholders:
   - If the owner(s) of the business/the shareholders are individuals, profit withdrawals or distributions should be subject to IIT. The withholding tax should alternatively be a final tax or deductible from the IIT obligation resulting from a tax assessment.
   - If the shareholder is a company, profit distributions should be exempt from CIT.
e) Cross-border situations: Profit distributions are dividends in the meaning of Art 10 OECD-MC. Profit withdrawals from a permanent establishment are deemed to be dividends in the meaning of Art 10 OECD-MC.

5.2. Reasons

Ad a)

To reach the aim of tax neutrality with regards to ownership of a business you can either tax companies like sole proprietors, that would mean fiscally transparent, or to tax sole proprietors or partnerships in a way similar to companies, which are taxed opaque.

Since business profits should be subject to income tax at the time of distribution or withdrawal, for surveillance reasons, the system of a uniform business tax should only be applicable to business profits calculated under double entry book keeping.

Ad b)

In many European countries, company profits are taxed at time of accrual at a flat rate which is significantly lower than the marginal IIT rate. One argument for the lower CIT rate is that retained profits are used for reinvestment and growth of the company. This argument is transferrable to profits of partnerships or sole proprietors. The advantage of a deferred taxation of business profits is – next to the benefits of limited liability – one of the main reasons why sole proprietors transfer their

[4] Greece (26 % CIT and 10 % IIT final), Hungary (limited partnerships), Russia (tax on profit of organizations), Slovenia , Slovakia.

business to a company. To avoid that retained profits are used for financial portfolio investments, such profits could be subject to a tax surcharge.

Ad c)

Withholding taxes have the aim to secure tax payments. Tax collection on basis of tax returns requires a vast amount of confidence. By the way, in case of a withholding tax, the tax administration usually receives the money earlier than in case of a tax assessment.

Ad d)

Business profits which are distributed to the owners of the business/shareholders of the company should form part of the owners´/shareholders´ income and be taxed at a cumulative tax rate (business tax plus IIT) which resembles the marginal IIT rate. The cumulative marginal tax rate of business tax and final withholding tax in my proposal amounts from 36 % (20 + 20-model) to 51 % (30 + 30-model).

The withholding tax on distributed profits should be creditable against the amount of IIT due to the gross income of the owner/shareholder. There should be no indirect credit for the business tax. For compensation, remunerations for personal services of the owner/shareholder should be deductible from the base of the business tax and form part of the owner´s/shareholder´s income as long as the payments are at arm´s length. Other remunerations than directors´ fees and salaries paid to owners/shareholders should not be deductible (see below 5.3.2.).

As a result, distributed/withdrawn business profits are always taxed at least at the tax rate of the business tax. This must be seen as a kind of a negative compensation for the advantage of a deferred taxation of distributed profits. The regulation not to give an indirect credit for the business tax, in addition, will probably increases the acceptance of the business tax system in cross border situations.

Distributed profits which were subject to business tax should not form part of the income of other resident companies.

Ad e)

Cross border situations are usually more complicated. Therefore it is always good to explain legal consequences with the help of an example.

Example:

An individual (P), a resident of State A, is running a business within State B. State A and State B have concluded on a DTC following the OECD-MC using the exemption method to avoid double taxation.

We suppose that State A and B are member states of the EU and levy the same taxes at the same rates as following:

IIT: 50 %; IIT on dividends: 25 % final

CIT: 25 %; CIT on dividends: exempt

What we now can see is, that according to the legal form used to run the business P will pay different amounts of taxes which are split up among State A and B at different ratios:

1. Sole proprietor P, having a PE in State B:

> State B will tax the income attributable to the PE at 50 %, State A has to avoid double taxation (exemption). Overall tax: 50 %, whereby State B will get all of it.

2. Shareholder P, holding 100 % in a company resident within State B

> State B taxes the corporate income at 25 % and collect a withholding tax from the dividend payment at 15 % (11,25). State A taxes the dividends at 25 %, but has to give a credit for the foreign withholding tax (18,75 – 11,25 = 7,5). Overall tax: 43,75 %, whereby State A gets 7,5 % and State B 36,25 %.

3. Shareholder P, holding 100 % in a company resident within State A. Company A is the parent company of Company B, resident within State B.

> State B taxes the corporate income of Company B at 25 %. Due to the Parent-Subsidiary Directive State B is not allowed to levy any source tax. The dividends are tax exempt in the hands of Company A. If Company A distributes the profit to P, it has to collect a tax of 18,75 (25 % of 75) at source. Overall tax: 43,75 %, whereby State A gets 18,75 % and State B 25 %.

The question, what is a state´s fair share in the tax cake, is an "evergreen" question of international tax law. We cannot answer this question at this point, although we finally have to answer the question on our way to find a neutral tax system in terms of legal ownership.

My proposal was to tax profit withdrawals like dividends in the meaning of Art 10 OECD-MA. In cross-border situations we need to rethink the term profit withdrawal. For cross-border situations it could make sense to define profit withdrawals as any withdrawal of retained profits from a PE regardless whether the profit is used by the owner of the business for consumption reasons or retained by the head office situated within the other Contracting State. In this field a lot more of research needs to be done.

Additionally, the state of residence of the owner of the business should take into consideration that profit withdrawals – like dividends – already were subject to business tax within the other state. That means, the state of residence of the owner should tax profit withdrawals in the same preferential way than it taxes dividends.

5.3. Miscellaneous

5.3.1. Losses

The possibility of the taxpayer to set off losses against other kinds of income is sometimes the only reason for choosing the legal form of a partnership for running a business, provided the partnership is taxed transparently. Within a system of a business tax, losses remain at the level of the business and cannot be deducted by the owner of the business. Of course, it must be possible at least to carry forward losses. It would be desirable to have a loss carry back. It should be discussed, whether final losses should be transferable to the owner of the business.

5.3.2. Director´s fees and other remunerations (interest, rent) paid to owners

In my proposal of a business tax, withdrawn profits are in any case subject to the 25 % business tax. There is no personal allowance for the owner of the business. As a compensation, director´s fees and other remunerations for manpower rendered by the owner should be deductible and be taxed as personal income of the owner. As to other remunerations like interest payments or rents I am of the opinion that such payments should not be deductible if made to the owner of the business or close relatives, but form part of the profit subject to the business tax. Such rule would prevent the possibility to shift income, which is subject to a flat rate tax, to income, which is due to a progressive tax rate maybe not taxed.

As far as income from the rental of immovable property is concerned, such rule does not cause a shift in the right to tax immovable property. As far as interest payments are concerned, such rule might cause a shift of the right to tax interest income from the state of residence of the beneficial owner to the state in which the debtor sustains a permanent establishment. Of course, such transfer of the right to tax can only occur if interest payments otherwise are deductible at all (e.g. interest payments from a transparently taxed partnership to one of its partners).

6. Conclusion

The in Europe commonly used system to tax corporate profits a first time at time of accrual in the hands of the company at a flat rate of 20 % - 30 % and a second time, when distributed to the shareholders, should be transferred to partnership profits and even profits of sole proprietors, provided that the profits are calculated under double entry book keeping.