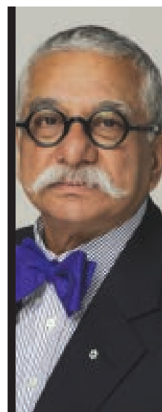
# The theory behind corporate taxes



TAX VIEWS

By Vern Krishna

Corporate migrations to lower tax jurisdictions have tax authorities concerned, particularly in countries with expanding deficits and accumulating national debts. Big governments need big money to finance their spending. Corporations are the natural first target, but there is less consensus about the right rate at which they should be taxed. The United States, for example, taxes at a rate of 35 per cent, Canada at about 25 per cent, the United Kingdom at 20 per cent, Ireland at 12.5 per cent, and Barbados at 2.5 per cent. Which is the ideal rate?

Taxing corporations as separate legal entities can result in double taxation and deferral of corporate taxes. Thus, the first question is whether we should have a separate corporate tax at all. What if we simply attributed income on an annual basis to the corporation's individual shareholders, regardless of whether the corporation actually paid out its income as dividends? Under this scheme, the corporation would merely be a conduit for its shareholders, in much the same way as a partnership is for its partners, or a trust is for its beneficiaries. By adjusting the tax rate on dividends, we could raise the same amount of revenues as we do under the dual regime of corporate and shareholder taxation.

Ultimately, only individuals pay tax. Artificial entities do not really "pay" tax — they are merely legal conduits for individuals who bear the real economic burden of taxation.

Although theoretically appealing, the concept of notionally flowing through corporate income to individual shareholders does not have much traction because of the practical problems that such a system creates. Notional flow-through of corporate income that would be taxed in the hands of individuals could create liquidity problems for some taxpayers if the corporation did not actually pay out cash dividends. Shareholders might be compelled to sell portions of their shareholdings to raise the necessary funds to pay their tax liabilities. This could have a significant effect on private corporations and the capital markets.

There would also be difficulties with corporate control if individual shareholders had to sell a portion of their shareholdings in order to raise cash for their tax bills. Corporate control could change from the liquidation of shares, and family-owned businesses in particular would be vulnerable. Private corporations might encounter difficulties in finding a suitable market for their shares, which would need to be valued annually if they were to be sold.

Also, non-residents would escape the income tax under Part I of the *Income Tax Act* and pay only the substantially lower withholding tax (generally five to 15 per cent) on dividends under Part XIII as modified by Canada's bilateral tax treaties.

The rationale for the structure of our corporate tax model becomes clearer if we accept the proposition that corporate income should not flow through and be taxed annually in the hands of individual shareholders. In the absence of a flow-through of income to shareholders, corporate income must bear its own tax annually if we are to prevent tax deferral. If corporate income is not taxed at its full rate, there would be incentive to accumulate income in the corporation in order to defer any tax that would otherwise be payable if it were paid out to shareholders. Thus, the prevention of tax deferral is an important reason for levying an annual tax on corporate income. As it is, however, within specified limits, we do allow Canadian-controlled private corporations to defer taxes on their active business income by taxing them at a corporate rate that is lower than top marginal rates applicable to individuals.

If we are to have a separate corporate tax, what is the ideal tax rate? The problem now assumes additional dimensions.

The corporate tax rate determines the extent to which one can defer tax by using the corporate form to conduct business. A corporate tax rate lower than individual rates invites deferral. Assume, for example, that the corporate tax rate is 25 per cent and that the top marginal rate for individuals is 50 per cent. If an individual can shift $200,000 income into his or her corporation and invest the tax savings ($50,000) at eight per cent per year, the tax saved will be worth $233,000 in 20 years. Thus, each dollar of tax savings accumulates to 4.7 times its value in 20 years. If the taxpayer could do this annually for 20 years, the tax savings for each year would accumulate to $2.521 million. If the individual sold his or her shares in the 20th year, the value of the tax savings would transform into a taxable capital gain of $1.260 million. If the capital gains tax rate is 23 per cent, the taxpayer, in addition to the tax deferral advantage, saves 27 per cent of $2.521 million, or $680,670. Thus, the taxpayer benefits both from tax deferral and from shifting his or her income to the corporation.

To be sure, we could eliminate tax deferral by making the corporate tax rate equal to the highest marginal rate for individuals. If we did this, the tax system would be substantially neutral at the top end, and businesses could make their decisions on the basis of non-tax criteria. There would be no tax deferral advantage to earning income through a corporation. A corporate rate equal to the top individual tax rate (approximately 50 per cent) would also remove business and economic incentives from those who presently obtain special low rates of taxation — for example, small businesses. Thus, any gain in tax neutrality between different types of taxpayers would carry with it the cost of lost tax incentives for certain sectors of the economy. This would have significant economic and political implications.

Several factors determine the corporate tax rate, but the desirability of having competitive international tax rates is increasingly important in an era of capital mobility. Canadian corporations must compete internationally, and the tax rates of our principal trading partners have a significant influence on the structure and location of Canadian corporations.

These rates attract inflows of capital investments into those jurisdictions, which raise other issues. For example, should there be special incentives for domestic investment over foreign investment? Should the corporate tax system favour domestic corporations that earn income within Canada over Canadian corporations that earn income in foreign countries? Should there be special tax incentives for foreign corporations that come into Canada to do business?

The answers to these types of questions determine the flow of corporate migrations and have tax authorities of big spending countries concerned.

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