A model to guard against double taxation

TAX VIEWS

By Vern Krishna

Taxing corporations as separate legal entities often results in double taxation, once at the corporate level and then again in the shareholder's hands. If double taxation is economically inefficient, we should integrate corporate and individual taxes.

There are two basic methods to relieve corporate double taxation: the conduit flow through method, and the imputation model.

Conduit flow through

Under the flow through method, a country can provide relief through special structures. For example, the U.S. provides relief to S corporations with fewer than 75 shareholders, and limited liability companies, by treating them as conduits for their shareholders.

Thus, under this system, the incidence of double taxation ultimately depends upon the type of corporation and the number of shareholders. Some corporate income is subject to double taxation, and other corporate income is not, which inspires complex hybrid structures to mitigate such consequences.

The imputation model

Under the Canadian imputation system, corporate income is taxed to the corporation, but the corporation's taxes are subsequently credited or imputed to the shareholder when it pays dividends. Thus, the shareholder eventually obtains relief for the corporation's taxes.

The imputation of income can be complete or partial. In a theoretically full imputation system, corporate and individual taxes would be fully "integrated," and income that flows through the corporation to its shareholders would be taxed only once.

Under this model, an individual who receives a dividend from a corporation "grosses up" the cash value of the dividend to a value that is notionally equivalent to the corporation's pre-tax income. The amount of the gross-up is a mathematical function of the underlying corporate tax rate.

For example, where a corporation earns $100 income and pays federal tax at 15 per cent, it has $85 remaining to distribute to its shareholders. If the corporation pays a dividend of $85 to an individual, he would gross up the dividend by 18 per cent for federal purposes and include $100, which is equal to the corporation's pre-tax income, in his income. Thus, the shareholder calculates his personal tax liability on the equivalent of the corporation's pre-tax income of $100. The individual then gets a credit for taxes ($15) equal to that paid by the corporation. Thus, the underlying principle of the imputation model is that the corporation's taxes are imputed to its shareholders as if they had paid them, and the shareholders claim a tax credit equal to the gross-up value of the dividends. In the above example, the federal corporate tax of $15 that we impute to the individual is integrated with the shareholder's personal tax.

To achieve this harmonious result, however, the corporate tax rate must be at least equal to the personal rate, so there is no systemic incentive to defer taxes by retaining income in the corporation. If the corporate tax rate is lower than personal tax rates, there is an incentive to retain earnings in the corporation in order to defer the higher personal tax payable on dividends.

The imputation model has its own problems. One of the difficulties of full imputation is that the shareholder receives a credit for taxes that the corporation notionally pays. This creates a problem where the corporation does not actually pay any tax on its income in the year. For example, a corporation may earn $100 income but pay no tax on it because it can reduce its taxable income to zero through fast write-offs of expenditures — such as capital cost allowance, research and development costs, depletion allowances, or other tax incentives or preferences. Thus, the imputation model is premised on an assumption that may not be valid in every situation. Nevertheless, it is a conceptually sound tax model.

There are no perfect solutions to the problems created by the potential for double taxation of income. In the interests of economic efficiency, however, we must be sensitive to the flight of capital from double tax jurisdictions to countries that have less punitive tax regimes, and to tax structures that are designed to game the tax system.

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