DUAL INCOME TAXES: A NORDIC TAX SYSTEM

Peter Birch Sørensen
University of Copenhagen

Presentation at the conference on
New Zealand Tax Reform – Where to Next?
Wellington, February 11-13, 2009

AGENDA

- What is a dual income tax?
- The case for the dual income tax
- Separating capital income from labor income: alternative ways of implementing a dual income tax
- Nordic tax practices
- A dual income tax for New Zealand?

WHAT IS
A DUAL INCOME TAX?

THE DUAL INCOME TAX: BASIC PRINCIPLES

- Progressive taxation of labour (and transfer) income combined with a low flat tax on all capital income
- The flat tax rate on capital income is aligned with the corporate income tax rate and with the marginal tax rate on labour income in the first bracket
- The capital income tax base is broad to ensure the greatest possible degree of tax neutrality

ALTERNATIVE BLUEPRINTS FOR THE PERSONAL TAX SYSTEM

- **The comprehensive income tax**: capital income is taxed at the same marginal rate as labour income
- **The expenditure tax**: the normal return to capital is exempt from tax
- **The dual income tax** as a compromise: capital income is taxed at a lower marginal rate than labour income

COMPONENTS OF THE CAPITAL INCOME TAX BASE UNDER A PURE DUAL INCOME TAX

- Interest
- Dividends
- Capital gains
- Rental income
- Royalties
- Imputed returns on owner-occupied housing
- Imputed returns on capital invested in non-corporate firms

Negative capital income deductible only against other income from capital

THE CASE FOR THE DUAL INCOME TAX

THE CASE FOR A *LOW* TAX RATE ON CAPITAL INCOME

- Accounting for *inflation*
- Accounting for *capital mobility*
- Improving tax *neutrality*

THE CASE FOR A *FLAT* TAX RATE ON CAPITAL INCOME

- Reducing *lock-in effects*
- Reducing the scope for *tax arbitrage*
- Reducing *clientele effects*
- Facilitating *tax administration*

ILLUSTRATING THE INFLATION ARGUMENT FOR THE DUAL INCOME TAX

Example:

- Nominal interest rate = 4%
- Inflation rate = 2%
- Tax rate on nominal capital income = 50%

Effective tax rate on **real** interest income:

$$0.5 \times 4/(4-2) = 2/2 = 100\%$$

CAPITAL MOBILITY: WOULD A LOW CORPORATE TAX RATE SOLVE THE PROBLEM?

- **Idea**: Keep the source-based corporation tax low, but keep the residence-based personal tax on capital income in line with the tax rate on labour income

Problems:

- Hard to enforce a high residence-based capital income tax
- Tax deferral and lock-in effects

SEPARATING LABOUR INCOME FROM CAPITAL INCOME

TAXING INCOME FROM SELF-EMPLOYMENT UNDER THE DIT

- **The problem**: the self-employed earn income from capital as well as from labour
- **Solution**: tax an imputed return to business assets as capital income and treat the residual business income as labour income

DEFINING BUSINESS ASSETS

- Depreciable business assets plus acquired goodwill and acquired intellectual property rights
- Business assets must be separated from "private" assets

TAX DESIGN FOR THE SELF-EMPLOYED

- Income splitting should be an option but not an obligation
- If the lowest marginal tax rate on labour income is aligned with the capital income tax rate and the upper threshold for the lowest tax bracket is high, many self-employed will never need to have their income split

TAXATION OF INCOME FROM CLOSELY HELD CORPORATIONS UNDER THE DUAL INCOME TAX

The income shifting problem

Active owners of small companies may transform labour income into capital income. In this way they may lower their total tax bill if the sum of the corporation tax and the personal tax on dividends and/or capital gains is lower than the (top) marginal tax rate on labour income

ONE POSSIBLE SOLUTION TO THE INCOME SHIFTING PROBLEM: TAXING ACTIVE SHAREHOLDERS LIKE PROPRIETORS

- An imputed return to corporate assets is taxed as capital income; the remaining part of corporate profit is taxed as labour income

Defining "active" shareholders:

- Ownership test
- Work test

PROBLEMS WITH MANDATORY INCOME SPLITTING FOR ACTIVE SHAREHOLDERS

- Active shareholders can invite new passive owners into the company, or they can swap shares with other active shareholders
- The dividing line between active and passive shareholders is essentially arbitrary

Norwegian experience: corporations subject to income splitting in

- 1992: 55 percent
- 2000: 32 percent

AN ALTERNATIVE SOLUTION TO THE INCOME SHIFTING PROBLEM: THE SHAREHOLDER INCOME TAX

- Impose a tax on dividends and capital gains at the shareholder level, but allow a deduction for a normal (after-tax) return on the basis value of the shares to ensure relief of double taxation

- If the sum of the corporate tax rate and the shareholder income tax rate on (after-tax) profits equals the (top) marginal tax rate on labour income, there is no gain from income-shifting, and hence no need for income-splitting

THE BASE FOR THE SHAREHOLDER INCOME TAX

Taxable shareholder income

= dividends

+ realized net capital gains on shares

- Rate-of-Return-Allowance (RRA)

Any unutilized RRA is added to the basis of the share and is carried forward indefinitely for deduction against future shareholder income

NEUTRALITY PROPERTIES OF THE SHAREHOLDER INCOME TAX

The step-up of basis + carry-forward means that the present value of future RRAs equals the initial stock investment, as if the shareholder were allowed **full expensing** of his investment. Hence the shareholder income tax is equivalent to a cash flow tax. It is therefore **neutral** towards

- real investment decisions
- financing decisions (retained versus distributed profits)
- realization decisions

FURTHER ASPECTS OF THE SHAREHOLDER INCOME TAX

- The shareholder income tax is a residence-based personal tax on income from foreign as well as domestic shares. The RRA strengthens the taxpayer's incentive to declare his foreign source shareholder income
- Corporate shareholders should be exempt from the shareholder income tax to avoid cascading effects

AN ALTERNATIVE: ALLOWANCE FOR CORPORATE EQUITY

Idea: Allow deduction for imputed return to (new) equity at the *corporate* level

Advantages (compared to shareholder income tax):

- Greater stimulus to investment
- Simpler administration

Drawbacks (compared to shareholder income tax):

- Larger revenue loss
- Deferral of personal capital gains tax provides incentive to accumulate income within the corporate sector (lock-in effect)

THE NORDIC CORPORATE TAX SYSTEMS

- **Finland**: only 70% of dividends from listed companies are taxed as capital income. Dividends from unlisted companies are tax exempt if they fall below an imputed return to the shares; 70% of dividends above that threshold are taxed as labour income
- **Norway**: shareholder income tax
- **Sweden**: no integration for listed companies. Dividends and capital gains accruing to 'active' shareholders in unlisted companies are taxed at a reduced capital income tax rate if they fall below an imputed return to the shares; dividends and capital gains above that threshold are taxed as labour income

A DUAL INCOME TAX FOR NEW ZEALAND?

NEW ZEALAND VERSUS THE NORDICS

The Nordic DIT countries:

- Total tax collections: 45-50% of GDP
- Top marginal tax rates on labour income around 50% plus social security taxes
- Relatively low international labour mobility

New Zealand:

- Total tax collections: 38% of GDP
- Top marginal personal income tax rate: 39%
- High international labour mobility

Implication: The case for the DIT may be weaker in New Zealand

A COMPREHENSIVE INCOME TAX FOR NEW ZEALAND?

Idea: Strengthen the principle of comprehensive income taxation but reduce distortions by

- Aligning the top personal tax rate with the 30% corporate tax rate
- Broaden the capital income tax base, e.g. by including capital gains in the base
- Relieve double taxation of distributed corporate profits by maintaining the full imputation system
- Relieve double taxation on retained corporate profits by allowing shareholders to add retained taxable profits to the basis of their shares

PROBLEMS WITH THE REFORM PROPOSAL

- Capital income would still be overtaxed, due to inflation
- Abatement of tax credits like the WfF would imply a very high effective marginal tax rate on (real) capital income if the phase-out were based on comprehensive (nominal) income
- If abatement of credits were instead based on labour income, the problem of separating labour income and capital income would reappear (so then why not move towards a clean DIT?)
- Tax competition will probably force a lowering of the corporate income tax rate, causing a potential lock-in problem if the personal capital income tax rate is not lowered too

ALTERNATIVE SOLUTIONS TO THE PROBLEMS

- A comprehensive "real" income tax: include only a fraction *X* of nominal income in the comprehensive income tax base, where *X* is the ratio of the average real interest rate to the average nominal interest rate

or

- A clean dual income tax with a shareholder income tax or an ACE system to prevent double taxation of the normal return to corporate equity