Towards a more neutral income tax system

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Abstract

Belgium is one of the many countries struggling to reform its income tax system. In the open and global economy of the 21st century, a more transparent and neutral tax system with fewer loopholes should be pursued.

The main aim of this paper is to analyze two important tax-induced distortions. First of all, the current income tax system is not neutral regarding the choice of the legal form of a business. Secondly, it is not neutral regarding the financing choice of a company between debt or equity. In order to improve economic efficiency, tax policy should be as neutral as possible by minimizing these distortions. Therefore, tax measures should not have a first-order effect on business decisions. However, multinational enterprises benefit from loopholes in the tax legislation of countries to evade and avoid taxes.

This contribution provides an overview of the historical evolution of business income taxation in Belgium and reveals new insights. Additionally, this paper focuses on some important research studies conducted by international organizations and by other countries which emphasize the need for more neutrality in tax reform.

1. Introduction

1.1. The need for more neutrality in tax policy

The basic concept of tax neutrality is simple: generally spoken, a tax system should strive to be neutral so that decisions are made on their economic merits and not for tax reasons [1]. The main purpose of tax systems is to raise the revenue that is required to pay for government spending. The goal is to raise this revenue without distorting the decisions that individuals and enterprises would otherwise make for purely economic reasons [2].

When policymakers impose higher taxes on sole proprietors than on incorporated enterprises, people would factor taxes into their choice of legal form and would not choose the economically most efficient form for their kind of business activities. In addition to distorting choices, non-neutralities in the tax system will also lead people and enterprises to devote a substantial part of their efforts to transforming the form or substance of their activities in order to reduce their tax payments [3].

The lack of neutrality towards the legal form of a business can also mean an infringement of the principle of equality, which is constitutionally guaranteed in many countries, including Belgium [4].

The European Commission has also made a recommendation concerning a more neutral taxation of small and medium-sized enterprises [5]. It gives a detailed examination of how enterprises are taxed and reveals a disparity in tax treatment depending on the legal form under which they operate. The recommendation indicates that because of their legal form, sole proprietorships and partnerships very often have to pay income tax on the whole of their income. The progressiveness of the personal income tax scale means that the marginal rates of this tax, while sometimes lower, are generally higher than the rates of corporation tax. The European Commission emphasizes that this creates distortions of competition between enterprises on the basis of their legal form, particularly since the self-financing capacity of sole proprietorships and partnerships is likely to be squeezed compared with that of incorporated enterprises of the same size or even larger, owing to their heavier tax burden. In some cases this may affect the very development of the enterprise. Because on average, in the EU one out of two firms is a not incorporated enterprise, this tax feature has a quite significant impact. Therefore, some Member States of the EU have themselves introduced tax arrangements based on the concept of tax neutrality between incorporated and unincorporated enterprises [6].

With regard to the non-neutrality towards financing choice of a company between debt or equity, we must emphasize that most corporate tax systems contain a debt-equity tax bias, because at arm's length interest payments are in principle tax deductible, while dividend payments are part of the corporate tax base. Debt-financing is thus favored over equity-financing via the tax deductibility of interest payments, which causes economic distortions and outward tax planning opportunities [7].

Firstly, the tax bias has an impact on the economic choices of companies: the choice to finance new investments with debt or equity. In this respect, it should be noted that highly leveraged companies experience an increased risk of bankruptcy.

Secondly, in an international context it may encourage outward tax planning opportunities. Some companies will shift reported profit via debt-shifting or the use of hybrid instruments [8].

In respect of the above reasons, it is clear that legislators should aim for minimalizing tax-induced distortions, such as the debt-equity bias and the lack of neutrality towards the legal form of a business.

Of course we acknowledge the fact that deviations from a neutral tax system can reflect certain goals of policymakers. A tax system can for example encourage home ownership. But it is highly debatable if a tax system is the best way to achieve these goals, especially considering the economic implications [9].

1.2. The unequal tax treatment of business income between sole proprietors and corporations

The current Belgian tax system is characterized by a lack of neutrality regarding the choice of the legal form of a company. This forms a tax-induced economic distortion [10]. A different set of tax rules apply to sole proprietorships (with no separate legal entities from the individual owner of the business) and incorporated enterprises (with separate legal entities from the owners). On one hand, the business income of sole proprietorships is directly taxed as a business income of the owner in the personal income tax and on the other hand, the business income of incorporated enterprises is directly taxed in the corporate tax. The main differences between personal income tax and corporate income tax concerning the income derived from the business activity are :

- There is an important distinction in terms of tax rates. In the personal income tax there is a progressive rate ranging from 25% to 50%, while a proportional rate of 33.99% applies to the corporate tax [11]. Although one can argue that on the distributed profits, a certain rate balance exists between personal income tax and corporate tax, there is more to it than this. The problem is that the majority of taxpayers will be taxed at an average tax rate of personal income that is higher than the tax rate for the corresponding amount of income in the corporate income tax. When a sole proprietor receives a total income of more than €37.330, he will be taxed in the personal income tax at the rate of 50%. Meanwhile, when an entrepreneur chooses to embed his business in a separate legal entity, such as a corporation, the lower rate of corporate tax will be applied and the owner can defer tax in time by booking long-term earnings as reserves in his corporation.
- The rules that apply to profits earned in the personal income tax form the basis for calculating the taxable profit relating to incorporated enterprises, but it is important to take into account that there is a set of exemption rules that apply to incorporated enterprises [12];
- Profits of a sole proprietorship are subjected to substantial additional social contributions, while this is not the case for profits of an incorporated enterprise [13].

1.3. The unequal tax treatment between debt and equity in corporate income tax

In the current Belgian tax system there are also severe consequences attached to the debt-equity choice. The main tax consequences relating to external financing for taxpayers subject to the Belgian corporate tax, can be summarized as follows [14]:

- Dividends are part of the tax base, while at arm's length, interest payments form a deductible business expense for taxpayers [15].
- In principle, on dividends and interest payments, a 25% withholding tax should be withheld. However, there is no withholding tax levied on dividends and interest payments if all exemption conditions of the Parent-Subsidiary directive and of the Interest-Royalty directive are met [16].
- The withholding tax can be offset against a company's corporate tax liability and can possibly be refunded to the extent that the withholding tax exceeds the corporate income tax due [17].
- Ninety-five percent of dividends received could be tax exempt if all the quantitative and qualitative requirements are fulfilled for the system of dividend received deduction, while received

interests are subject to corporate income tax [18].

- Incorporated enterprises subjected to corporate income tax can benefit from deduction from their taxable base in the form of fictitious interest deduction calculated on the basis of the risk-bearing adjusted net-equity of the company or Belgian permanent establishment. This deduction is called the notional interest deduction. For small companies, this deduction is increased with 0.5% as a favourable measure [19].
- Thin capitalization rules can be applied if a company is being excessively funded by debt [20].

2. Legal historical evolution in Belgium

2.1. The Belgian tax system in the past : more neutrality?

The authors have researched and analyzed the four main legislative reforms in the history of the Belgian tax system. These reforms are relevant to show the evolution of the taxation of business income. These four reforms include the Act of May 21^{st}, 1819 that introduced the patent tax on corporate profits, the Act of September 1^{st}, 1913 that changed the patent tax for incorporated enterprises thoroughly; the Act of October 29^{th}, 1919 that introduced the schedular income tax system and, finally, the Act of November 20^{th}, 1962 that introduced the Belgian current global income tax system with on the one hand the personal income taxation and on the other hand the corporate income taxation [21].

The Belgian legal history shows that the legislator initially wanted to obtain neutrality of legal form, meaning that the tax is levied regardless of the legal form in which an entrepreneur wished to exert his activity. An example of this is the business tax in the schedular tax system that applied to business profits derived from all sorts of enterprises regardless of their legal forms. Only later the legislator became aware of the consequences of the unequal tax treatment between debt and equity. We believe that striving for a system in which taxation is neutral towards the chosen legal form may be a justification for the unequal treatment between equity and debt. In the past, the shareholder was considered as an extension of the company. Moreover, shareholders were considered both as the controllers and the owners of the company [22]. The legislator wanted to affect the shareholder by taxing corporate earnings. At the same time, the legislator assumed that the payment of interests impoverished the incorporated enterprise, and thus also indirectly the shareholder. Nowadays, there is a separation of ownership and control in large companies: the management instead of the shareholders really control the company [23].

In 1962, the corporate income tax in Belgium was designed as a withholding device for the personal income tax [24]. When a dividend was paid by the incorporated enterprise, the underlying corporate taxes were credited against the personal taxes of the shareholder. In addition to this first measure, the (imputation) tax credit, there was also a second measure, namely an optional system for small companies [25]. This optional system implied that certain smaller companies could choose that their profits were either taxed in the personal income tax with the shareholders of the company or separately taxed in the corporate income tax. A third measure that enhanced neutrality of legal form was a higher rate of corporate income tax that was also implemented in 1962 for reserved earnings [26]. Therefore, it was made less attractive for companies to book long-term profits as reserves and defer tax in time. However, the above-mentioned tax credit, optional system and higher rate for long-term reserved earnings were rather short-lived measures that emphasized neutrality of legal form in the tax system.

Although there was an initial implementation of neutrality towards the legal form of a company, the measures that really emphasized the neutrality were not applied for a long time. Neutrality or lack thereof, towards debt and equity in tax treatment were not a priority or a conscious choice of the Belgian legislator in the past.

2.2. The current and future Belgian tax system : need for reform?

Since the abolition in the eighties of the above-mentioned measures that entailed more neutrality towards the legal form of a company, there has been a growing lack of neutrality of legal form in the Belgian tax system. For many sole proprietors it is much more interesting to conduct their business in a the form of a separate legal entity, such as a corporation, only for tax purposes. Therefore, future tax reforms should not only depend on budgetary needs of the government in the short term, but should also be based on a reinstatement of previously existing principles that underpinned the tax regulations, such as the pursuit of more neutrality of legal form. One can consider to reinstall the above-mentioned measures, for example the optional system. However, one must take into account that the benefit of a different rate will remain if such a system for taxable persons is optional. Hence, such a system can probably only be effective in our current tax system if it is made mandatory. This in turn entails a new problem, namely which companies will be obliged to be taxed in the personal income tax. The reverse solution forms also a possibility, namely that all types of enterprises, including sole proprietors, are taxed in the corporate income tax on their business profits. This would also entail a rapprochement to the old business tax of 1919 which made entirely no difference towards the legal form of the enterprise.

A more pragmatic reform of the Belgian tax system could entail a return to the diversified corporate tax rate of 1962, in which reserved earnings were taxed more heavily than distributed profits.

Another approach could be to focus more on the specific differences that exists between large (multinational) enterprises and small enterprises and provide in more customized measures for each category. In this case it would still be possible to categorize the sole proprietorships under the small enterprises. The current tax system only exceptionally provides in some measures in favour of certain small companies (i.e. with separate legal entities), for example a higher rate of notional interest deduction.

All companies that are subjected to corporate income tax can normally benefit from the notional interest deduction. However, this system is based on a weaker existing relationship between shareholders and corporations than the one that was presumed in the former measure of an imputation tax credit. From this perspective, it is rather maladaptive that the small companies which usually have a stronger relationship with their shareholders than large companies, receive a higher deduction of risk capital.

It is self-evident that policymakers should not only pursue more neutrality of legal form in future reforms, but should also pursue a more neutral and equal tax treatment of equity financing relative to debt financing. The tax legislation should not lead to a situation in which an entrepreneur's financing choice is being primarily influenced by fiscal considerations. Therefore it is essential that these tax-induced economic distortions are minimized as much as possible in future tax reforms.

The legislator can achieve this by granting an imputation tax credit to shareholders. In that case shareholders receive a tax credit which corresponds to at least some part of the corporate income tax which has been paid on the profits that are distributed as dividends. However, reintroducing an imputation tax credit for shareholders could be difficult in respect of the freedoms of the European Union, namely the free movement of capital and the freedom of establishment. A discrimination of those principles arises if dividends that are paid to residents by resident companies are treated differently than those paid to residents by non-resident companies [27].

Another possibility is to maintain the current system of notional interest deduction. In the present economic climate, however, this deduction is put into question, since it is assumed that companies overcapitalize to reduce their taxable base by this deduction. Such abuse could possibly be restricted by introducing different tax rates for distributed profits and reserved earnings. Once the total amount of retained earnings exceeds a certain limit, the retained earnings could be taxed more heavily than the distributed profits.

An alternative to the above-mentioned measures may consist of making the interest partially non-deductible under certain conditions, as specified in the current undercapitalisation rules for companies. Finally, there is also the option of introducing a system of defiscalization of interest. This means that interest is non-deductible (for the debtor) and non-taxable (for the creditor) for corporate income tax. Although the Act of September 1st, 1913 considered the interest payments as a profit component, defiscalization of interest for companies was never mentioned. Merely the interest payments and fees were included under the Act of 1913. Furthermore, this system led to a further erosion of the tax base in cross-border situations, since the interest is mostly deductible by the debtor.

Consequently, we can only agree with the Finance Minister of Belgium when he recently mentioned that the basic principles of the tax reform of 1962 are lost in the current system of income taxes and that this is deplorable. He also stated that there is need for future reforms, but that there is still a lack of broad political support to succeed in a thorough tax reform [28].

3. The points of view of international and country reports regarding more neutral tax systems

3.1. The OECD

The OECD (Organization for Economic Co-operation and Development) stipulates in its paper 'Tax and Economic Growth' that there is a wide consensus that taxation should avoid discouraging efficiency improvements and aim at ensuring neutrality and consistency, for instance, by not favoring some kind of investments or firms at the expense of other investments or firms [29]. Therefore the OECD agrees that neutrality towards the business legal form and towards the financing choice of an enterprise is a right approach.

According to the OECD the approach of a low corporate tax rate with few exemptions and thus base broadening, would minimize tax-induced distortions and increase the efficiency of tax systems.

Concerning special tax reliefs based on firm size, the OECD concludes that such reliefs could result in economic inefficiencies as resources may be wasted. Moreover, cuts in the overall statutory corporate tax rate were found to be more beneficial for enhancing economic growth.

The choice of treatment by a country of corporate equity income can definitively have implications for economic growth according to the OECD. The problem of double taxation of corporate equity creates disincentives to invest and discriminates against equity finance in favor of debt and therefore tilts the playing field in the direction of companies that easily obtain debt finance. This also implicates negative effects for small firms in particular due to greater costs. The OECD states that generally the double taxation of dividends may inhibit firm growth and has negative consequences on economic performance. According to the OECD the allowance for corporate equity, such as the Belgian system of notional interest deduction, provides a valuable solution to overcome the distortion of the choice between debt and equity as sources of finance at the corporate level.

There is also a warning from the OECD that the possibility of tax minimization by shifting income between corporate and personal income taxation needs to be taken into account when designing a corporate tax system. If personal income is taxed at a significantly higher rate than corporate income this may encourage an entrepreneur to classify his income as corporate instead of personal. Consequently, this would reduce tax liabilities, erode the tax base and lower overall tax revenues collected by a country.

3.2. The 'Mirrlees Review'

The 'Mirrlees Review' is the result of a thorough research conducted by an independent organization in the UK in 2011 [30]. The goal of the 'Mirrlees Review' was to determine the characteristics of a good tax system for an open economy in the 21st century and to give recommendations on how the system in the UK could be reformed.

According to the authors of the 'Mirrlees Review' small companies should be treated as little as possible in a 'special' way. The report pleads on the one hand for an income tax that is as neutral as possible towards the legal form of business entities. On the other hand it pleads for effective tax rates that are as similar as possible for all groups of entities, from the employees to the companies.

An adjustment to the current tax system in the UK may consist of the equalizations of social contributions for employees and sole proprietors, along with an increase in the rate of corporate income tax for small companies to the standard higher standard rate of corporate income tax.

A more fundamental change proposed in the 'Mirrlees Review' is to exempt, both in personal income tax and in corporate income tax, the normal profitability in the form of a rate or return deduction. The 'Mirrlees Review' states that the return to capital should be more lightly taxed than the return to labor. It prefers a solution with a combination of a shareholder income tax with a rate of return allowance and a corporate income tax with an allowance for corporate equity. This system would exempt the normal rate of return to capital from taxation at both the corporate and the personal level, but at the same time provide a mechanism for taxing above normal returns to capital and labor income at the same progressive rates. By doing so, it remains the case that equalization of the effective tax rates applied to the different legal forms is necessary to tax owner-managed enterprises in a sensible and neutral way, but this can be achieved without prejudicing the capacity of the tax system to effectively distinguish between normal returns to financial capital and labor income. Therewith, a more neutral way of taxing businesses and choice of financing can be obtained.

Aside from the allowance for corporate equity, which is a similar system to the Belgian system of notional interest deduction, the 'Mirrlees Review' also discusses the possibility of a system where interest expenses are no longer deductible for incorporated enterprises (defiscalization of interest).

A disadvantage of the first recommended system, the allowance for corporate equity, is that it results in a lower tax base. Therefore, the statutory rate would have to increase in order to obtain a budget neutral reform, because this system forms an incentive for corporations to shift their profit. According to the 'Mirrlees Review' the system of defiscalization can only be implemented given a long transition period.

3.3. The report 'Van Weeghel'

In 2010, the Dutch Tax System Committee, led by Van Weeghel, published a report on the improvement and simplification of the tax system in the Netherlands [31]. This committee also offered important recommendations concerning greater neutrality in a tax system.

According to this report, the only shareholder of a small company with a separate legal identity and a sole proprietor should be treated as similar as possible. This report agrees with the 'Mirrlees review' that capital income should be taxed at a lower rate than labor income.

The committee has also taken under consideration the possibility of a limited fiscal transparency for certain companies with only one business owner (shareholder). This implies a taxation directly at the level of the shareholder behind the company.

In regard to the possibility of an allowance for equity, the committee stipulates that more neutrality of business legal form can be obtained if this would also be implemented for sole proprietorships, and not only for companies subjected to corporate income tax.

Concerning the different treatment of equity and debt, the committee also suggests the allowance for corporate equity. Otherwise, it also suggests the possibility of defiscalization. In that case there is a neutral and equal treatment of debt and equity. Nevertheless, a great disadvantage is the effect this would have on investors in real activities who usually finance largely with debt.

All of the above-mentioned reports emphasize the importance of measures that effectuate a higher level of neutrality in the tax systems.

4. Conclusion

It is preferable that a tax system strives to be neutral so that decisions are made on their economic merits and not for tax reasons. Various (international) reports concerning tax reform affirm that legislators should aim for minimalizing tax-induced distortions.

First of all, the current income tax systems should be more neutral regarding the choice of the legal form of a business. Secondly, it should be more neutral regarding the financing choice of a company between debt or equity.

The legal historical evolution of the tax system in Belgium proves that initially there was neutrality towards the business legal form in the system of the schedular taxes. When the corporate income tax was introduced in 1962, an integrated approach of the personal income tax and the corporate income tax was the design. This can be demonstrated by three measures that also enhanced neutrality in the tax system : firstly, the (imputation) tax credit, secondly the optional system for certain small companies and lastly, the higher rate in the corporate income tax for reserved earnings. Unfortunately, all these measures are abolished in the current Belgian tax system. For future reforms it could be useful to return to these 'neutrality enhancing' measures from the past.

Whereas the shareholders were initially presumed to be the extension of the company and presumed to be the controllers and the owners of the company, this is no longer the case for large corporations nowadays. Therefore it might also be useful to design specific rules for large corporations on the one hand and small companies and sole proprietorships on the other hand.

When we study the current Belgian tax system and international and country reports regarding tax reform, there is certainly a growing awareness concerning the need for a neutral tax treatment of debt and equity. An exquisite example that realizes a similar treatment of equity and debt is the current Belgian notional interest deduction or the allowance for corporate equity suggested in the paper of the OECD, the 'Mirrlees review' and the report 'Van Weeghel'. Another possibility consists of the defiscalization of interests.

The need for neutrality towards the legal form of a business is also emphasized in the reports, but the methods to achieve more neutrality at this point are not explained very clearly. Probably a more analog approach of corporate income taxation and personal income taxation can be read between the lines.

Finally, it is important to stress the need for further development in measures that minimalize tax-induced distortions. Because tax purposes should not outweigh in economic decision making such as the choice of a legal form of a business or the choice between equity and debt.

After all, there is a broad consensus that taxation should avoid discouraging efficiency improvements and aim at ensuring neutrality and consistency.

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