Dual Income Taxation as a Stepping Stone Towards a European Corporate Income Tax[1]

Bernd Genser and Dirk Schindler

University of Konstanz

Introduction

Although globalization in trade and in particular in financial markets forced national governments to adjust their capital income tax regimes to capital mobility and to strategic tax competition since the mid 1980s, there is evidence that national governments facing this increased pressure have an interest in taxing corporate income at the national level. This interest is also true for EU member states but it has not led to coordinated actions in the past. The Commission denied the necessity of harmonizing corporate income taxation when the proposals of the Ruding Report[2] were discussed in the early 1990s. One reason was certainly the EC Treaty which although fundamentally revised and extended by the European Single Act and the Treaty of Maastricht only addresses the harmonization of commodity taxes. There have, however, been agreements and EU directives concerning the abolition of income tax discrimination for transborder capital flows (merger directive, parent subsidiary directive), improved transborder cooperation of tax authorities (administrative assistance, arbitration convention), or harmful tax practices (code on conduct on business taxation). Objectives behind these measures have been competitiveness in the internal market and administrative issues rather than revenue and tax policy targets.

The Bolkestein report[3] marked a change in the EU's position towards capital taxation by stressing the importance of supranational coordination of capital taxation. Most member countries seem to subscribe to the necessity for stronger capital income tax coordination, but little if any progress can be identified. Governments are very reluctant and unwilling to shift competences in capital income taxation to the EU, because this is recognized to have major fiscal repercussions on national income taxation and national tax revenue. To overcome this standstill Sijbren Cnossen recently proposed an agenda for capital income tax coordination in the EU, which in his view should pave the way to broader political support.

The paper is organized as follows. The Cnossen agenda, which calls for the introduction of a dual income tax (DIT) in EU member countries as a first step, is presented in section 2.

[1] We are indebted to Andreas Reutter for helpful comments.

[2] European Commission, Report of the Committee of Independent Experts on Company Taxation, Luxembourg. (Ruding report), 1992.

[3] European Commission, Company Taxation in the Internal Market, SEC 1681, Luxembourg. (Bolkestein report), 2001

The characteristic features of a pure dual income tax are sketched in section 3. Section 4 discusses the current DIT system in the Nordic countries, which after recent reforms differs from the traditional DIT system implemented in the 1990s. In section 5 we show that tax reforms in many other EU member countries introduced DIT type schedular tax elements. This is also true for the most recent German tax reform, which we sketch in section 6. We argue in the concluding section 7 that both the deviation from pure DIT in the Nordic countries and the reform steps in non-DIT countries may prove beneficial for the Cnossen reform agenda.

The Cnossen Agenda for a Coordinated European Capital Income Tax

Based on important common features in the very heterogeneous picture of highly diverse capital income tax traditions across the EU, Sijbren Cnossen[4] proposes a corporate income tax coordination agenda which comprises five sequential steps:

1) All member states introduce a dual income tax system, which taxes capital income at a single flat rate below the top rates on separately taxed labour income. The low flat rates on capital income at the personal level should mitigate the distorting effects of effective capital tax differentials due to corporate and personal tax rates on capital income.

2) All member countries introduce a flat withholding tax on interest income at a rate that equals the national corporate income tax rate. This mandatory interest tax should treat interest and dividend income alike and mitigate incentives for debt financing and thin capitalization.

3) The EU recommends an approximation of corporate income tax rates among EU member states, e.g., by introducing a lower bound to reduce transfer pricing incentives.

4) Based on the results attained by steps 1-3 the EU proposes the introduction of an EU-wide comprehensive business income tax[5] which uses a common tax base in all member countries, in line with the proposal raised in the Bolkestein report. The comprehensive business income tax does not allow for deducting interest from the income tax base and treats returns on equity and bonds symmetrically. This is, however, no change in the economic returns, because the withholding tax introduced in step 2 already made the tax system equivalent to a

[4] S. Cnossen, The Future of Corporate Income Taxation in the EU, in: Austrian National Bank (ed.) Capital Taxation after EU Enlargement, Proceedings of OeNB Workshops No. 6, Vienna, 2005, pp. 165-201; S. Cnossen, Reform and Coordination of Corporation Taxes in the European Union: An Alternative Agenda, in: Bulletin of International Fiscal Documentation, 2005, pp. 134-150.

[5] See, e.g., S. Cnossen, Company Taxes in the European Union: Criteria and Options for Reform, in: Fiscal Studies 17, 1996, pp. 67-97.

comprehensive business income tax. The splitting of the common tax base of multinational companies must be solved by formula apportionment.

5) The final long-term harmonization step is a European corporate income tax with a single tax rate set by the Council of the EU.

In his evaluation of the five agenda steps Cnossen is reluctant and inserts a break after step 3 for a fresh review of the Bolkestein proposals. He also admits that a true European corporation tax requires fundamental changes in the EC Treaty. In the following we concentrate on steps 1-3 and show that recent tax reforms in the EU member states have provided an even more favourable environment for the Cnossen agenda.

Characteristic Features of a Pure DIT

The most characteristic feature of a DIT[6] is its tax base split of total income into capital and labour income. Both kinds of income are liable to separate tax rates respectively tax scales. The higher degree of freedom for tax policy allows for reducing the excess burden of income taxation.[7]

Assigning income from different economic activities to the two schedules is clear for traditional income classes: wages and salaries, as well as fringe benefits, but also social security transfers and pension payments belong to labour income. Interest income, dividends, rents and capital gains in real capital assets (including property) are classified as capital income. The tax base split is, however, more complicated for business income, because business income is an aggregate consisting of return to capital invested into the firm and of employer's salary, paid for its work in the firm. Dividing up this aggregate has been regarded as the "Achilles Heel" of a DIT,[8] and two different methods for coping with this problem were developed. Under the *source principle* an imputed capital return on business assets determines capital income and the residual annual profit is taxed as labour income. Under the *fence principle* business income is taxed as capital income, as long as profits are retained, and the split into capital and labour income is only enacted, when profits are distributed to the owners. Unfortunately, both methods generate problems, e.g., discrimination, lock-in effects,

[6] See, e.g., R. Boadway, The Dual Income Tax System: An Overview, in: CESifo Dice Report 2 (3), 2004, pp. 3–8; S. Cnossen, Taxing Capital Income in the Nordic Countries: A Model for the European Union?, in: FinanzArchiv 56, 1999, pp. 18–50, B. Genser, A. Reutter, Moving Towards Dual Income Taxation in Europe, FinanzArchiv 63, 2007, forthcoming; P.B. Sørensen (ed.): Tax Policy in the Nordic Countries, Macmillan, London, 1998; P.B. Sørensen, Dual Income Tax: Why and How?, in: FinanzArchiv 61, 2005, pp. 559-586.

[7] This was first shown in A.B. Atkinson, A. Sandmo, Welfare Implications of the Taxation of Savings, in: Economic Journal 90, 1980, pp. 529—549.

[8] P.B. Sørensen, From the Global Income Tax to the Dual Income Tax: Recent Reforms in the Nordic Countries, in: International Tax and Public Finance 1, 1994, pp. 57–79.

overcapitalization.[9] These were one reason for DIT reforms in the Nordic countries discussed in the next section.

Under a pure DIT, all capital income is taxed at a flat rate, whereas labour income is liable to a progressive tax schedule. In order to prevent tax arbitrage incentives and possibilities – at least for low-income earners – the lowest labour income bracket is set equal to the capital tax rate. Personal allowances can be deducted from labour income implementing indirect progressivity also for the lowest labour income bracket. These allowances should, however, be precluded for capital income in order to sustain the advantage of final withholding taxes.

In case of negative capital income, loss offsets are granted. Two ways are possible: the somewhat critical first option is to offset capital losses against positive labour income – thereby reintroducing an element of comprehensive income taxation. The preferable second option is a capital income tax credit, which can be used to balance other tax liabilities.

A last important feature of a pure DIT is the abolition of double taxation of dividend income by corporate and personal income taxes. If the corporate tax rate is equal to the DIT rate on capital income, full integration can be accomplished efficiently either by exempting dividends from the withholding tax (either directly or via a corporate income tax credit) or by deducting dividends from corporate income tax base. In any case, the incentive to retain company profits vanishes.

The Current DIT System in the Nordic Countries

Norway, Finland and Sweden implemented dual income tax systems in the early nineties, which taxed interest income and dividend income of passive shareholders at a flat rate, which was equal to the first bracket rate on progressively taxed labour income. Another characteristic feature was mandatory income splitting for entrepreneurial income of active shareholders in closely held companies and of proprietors or partners in non-incorporated businesses. The required splitting of compound income into a capital and a labour income component was based on the imputation of capital income by applying a publicly fixed normal rate of return on entrepreneurial assets. This imputed capital income was taxed at the flat rate on capital. The residual business income was regarded as labour income and taxed progressively.

[9] See, e.g., A. Alstadsæter, The Achilles Heel of the Dual Income Tax. The Norwegian Case, in: Finnish Economic Papers, forthcoming.

Apart from difficulties in defining the two tax bases appropriately due to the tax incentive to transform highly taxed labour income into preferentially taxed capital income, there was a systematic bias in the treatment of capital income. Capital income from passive shareholding was subject to the low capital income tax rate on dividends irrespective of its rate of return. Imputation of capital income from active ownership implied that only the normal rate of return was taxed at the flat rate, whereas excess returns were regarded as labour income and taxed progressively. Sweden was the first Nordic country to break with the dual income tax reform and to switch back to double taxation of dividends from passive shareholding in 1994. Recent tax reforms in Finland (2005) and Norway (2006) changed their DIT systems in a similar way. Denmark already gave up full integration in the parliamentary discussion on the tax reform act and introduced a reduced personal income tax (PIT) regime in 1987.

Thus the current DIT systems in the Nordic countries may be regarded as triple rather than dual income taxes as capital income is split up into two components, a normal return to capital and an excess return to capital. Only the normal return to capital is subject to the low capital income tax rate, whereas the excess return to capital is subject to a higher rate. This higher rate is accomplished by double taxation: capital income above the normal rate of return bears the corporate income tax rate and a reduced flat rate on capital income. For active shareholders and proprietors excess returns are still taxed at the labour tax rate. Although there is still some discrimination between taxing excess returns in both forms of business, the gap has become significantly smaller.

Table 1 provides the relevant tax rates for the four Nordic countries in 2006. In Norway dividends are taxed at the corporate income tax rate of 28%. At the personal level dividends are subject to a flat rate of 28%, but a rate-of-return allowance exempts the part of dividend income which reflects the normal rate of return. Capital income below the rate-of-return allowance gives rise to a carry-forward of unused allowances. Income splitting for non-incorporated firms is maintained and charges capital income reflecting the normal rate of return with the 28% flat rate, whereas the remaining income (including excess returns on capital) is taxed at progressive rates.

In Finland the 2005 tax reform reduced the corporate income tax rate from 29% to 26% and the withholding capital income tax rate from 29% to 28%. The imputation system was abolished. Double taxation of dividends from listed companies is mitigated by exempting 30% of dividend income which implies a flat rate of 19.6 %. Dividends from unlisted companies are exempt up to a dividend threshold by the normal rate of return allowance.

Dividends exceeding the threshold are taxed at 19.6% for capital yields below the normal rate of return and are taxed progressively as excess dividend income else.

Sweden reintroduced double taxation of dividends already in 1995. The flat rate of 30% is applied to all capital income at the personal level, i.e. to dividends from listed companies, interest income and capital gains. Dividends from unlisted companies are subject to a normal rate of return allowance. Dividend income in excess of the normal rate of return is taxed at the flat rate for passive shareholders, but is taxed progressively as earned income for active shareholders.

Denmark was the first country to implement a dual income tax reform as early as 1987, but the government's proposal was modified already in the parliamentary process and capital income was never taxed at a single flat rate[10]. The Danish income tax code distinguishes personal income, capital income and income from shares. But only income from shares is taxed at reduced rates, whereas personal and other capital income, in particular interest income, is taxed according to a progressive schedule. Income from shares is double taxed at the corporate and the personal level. Dividends are taxed at a reduced rate of 28% if dividend income is below a threshold and at 43% if it is above. A separate schedule is applied to capital gains.

DIT Type Tax Systems in the EU

Except for the Nordic countries (including Norway), none of the other EU members has introduced a fully fledged DIT, but half of them have implemented major steps from a comprehensive income tax towards a DIT.[11]

There is a final withholding tax on all capital income in Austria, Belgium, Italy, Portugal, Lithuania, Poland and the Czech Republic,[12] whereas all these countries apply a progressive tax scale on labour income. Estonia does not tax capital income at the personal level and charges a flat tax rate on earned income. Preferential treatment of capital income is also found in the Netherlands and in Greece, where the latter furthermore differentiates tax rates of dividend and interest income. France introduced a final withholding tax only for personal interest income.

[10] The Danish tax system is a hybrid between a DIT and a comprehensive income tax and exhibits characteristic DIT features only for taxpayers with negative net capital income.
[11] See, e.g., Genser and Reutter (2007), op. cit.
[12] In some countries, however, the tax rate on capital gains can differ from the tax rate on interest income and dividends, e.g. in Belgium and Portugal.

Although schedular capital taxation constitutes the major step towards DIT there are still important differences to the Nordic DIT. None of the countries above splits business profits into capital and labour income for closely held corporations or non-incorporated firms. Compared to a pure DIT all these countries double tax dividends – except for Greece and Estonia, which exempt dividends. Double taxation is, however, mitigated by reduced personal income tax rates or, in France, by a reduced dividend base.

Whereas the Nordic countries still provide some loss offset rules in case of negative capital income, such offsets are granted fully only in Greece and in a limited form in France. In contrast to a pure DIT Lithuania, the Netherlands, France, and Estonia provide a basic allowance also for capital income, whilst Austria and Belgium offer a filing option. In these two countries, low income tax payers can opt for taxing capital and labour income comprehensively at the progressive (labour) schedule. Finally, the corporate income tax rate coincides with the personal income tax rate on capital in Austria, Lithuania and Poland, but differs in the other countries.

Although the non-Nordic countries listed in table 1 did not introduce a dual income tax system, there is evidence for some convergence in capital income taxation in these countries and in the Nordic countries. The common features are the final withholding tax on interest and dividend income and the schedular triple income tax structure which exhibits some similarity to the present Nordic countries after their recent DIT reforms.

The German Tax Reform 2008/2009

In Germany, there have recently been several proposals for a tax system switch towards a true DIT,[13] accounting for the fact that loopholes and exceptions from comprehensive income taxation did already constitute some kind of schedular taxation. In March 2007, the German federal cabinet agreed on a major tax reform, which passed the Bundestag on 25 May 2007.[14] The reform will be enacted in two steps in 2008 and 2009, and although it is announced as corporate tax reform, most changes refer to the personal income tax code – but fail in achieving a real DIT.

In 2008, the corporate income tax rate will be decreased from 25% to 15% and will then be equal to the lowest personal income tax rate. Incorporating the local business tax

---

[13] See, e.g., C. Spengel, W. Wiegard, Dual Income Tax: A Pragmatic Reform Alternative for Germany, in: CESifo Dice Report 2(3), 2004, pp. 15–22; German Council of Economic Advisors, Reform der Einkommens- und der Unternehmensbesteuerung durch die Duale Einkommensteuer, Wiesbaden, 2006.

[14] See Bundesministerium der Finanzen, Entwurf eines Unternehmensteuerreformgesetzes 2008. Gesetzentwurf der Bundesregierung, Berlin, 2007.

(Gewerbesteuer), the statutory tax burden on company profits will decrease from 38.65% to 29.83%. To curb strategic profit shifting subsidiaries of multinational companies face a ceiling for interest deductions at 60% of net financial expense above a threshold of one million euro. This interest threshold *(Zinsschranke)* constitutes an element of a comprehensive business income tax. There is, however, the possibility to avoid the interest threshold if the German subsidiary proves that the debt structure is typical for the company worldwide and does not reflect thin capitalization.

From 2009, personal capital and labour income will be taxed at separate schedules. For labour income, the progressive income tax schedule is maintained but capital income is going to be taxed at a flat rate of 25%. This tax rate will not only apply to interest income and dividends, but also to capital gains on assets bought after 31 January 2008. Thus, the current exemption of capital gains, being realized after defined holding periods, will be eliminated. Moreover, non-incorporated firms can opt for preferential taxation of retained earnings at a flat rate of 28.25%. This equals approximately the tax rate on corporate profits. Although non-incorporated firms are liable to the business tax (Gewerbesteuer) as well, the compound tax burden remains largely unchanged because of an imputed business tax credit. If these retained earnings are withdrawn by the owners, they will be treated like dividends and taxed at the flat rate of 25%.

The tax reform fails, however, in achieving a DIT, because there is no splitting of business profits in non-incorporated firms. Moreover, dividends are double taxed at the company and the personal level, though at competitively low tax rates. The German tax system will therefore create tax deferral incentives and lock-in effects. Final withholding taxation is eroded by keeping a personal savings allowance (*Sparerpauschbetrag*) of 801 Euro, and a filing option for capital income of tax payers, whose marginal (labour) tax rate is below 25%. On the other hand, costs of earning capital income will be no longer deductible.

Towards a Common Structure of Capital Income Taxation in Europe

When the Ruding Report was published in the early 1990s Europe was characterized by sharply contrasting income tax systems: Whilst the Nordic countries introduced a pure DIT, the other EU member states defended their comprehensive income tax systems and started introducing final withholding taxes only as a backstop against tax evasion and as a cut in tax administration costs. At that time, a proposal similar to the Cnossen agenda would have

appeared unrealistic and naïve. Fifteen years later, tax reforms across Europe have changed the environment for tax coordination.

On the one hand, the Nordic countries reformed their pure DIT systems and reintroduced some double taxation of company profits. Problems in income splitting for business income in closely held corporations and in non-incorporated firms led to a further splitting of capital income into a normal return and an excess return component. These excess returns are subject to double taxation and thus bear a higher rate than normal returns, which are taxed only once.

On the other hand, the majority of the other EU members left their comprehensive income tax tradition far behind and introduced or plan to introduce withholding capital taxes, which are flat and lower than tax rates on labour income. Schedular taxation is, however, not extended to business profits of closely held corporations and non-incorporated businesses.

Taken together, there seems to be convergence to a modified form of DIT: Labour income is still taxed progressively and the normal rate of return to capital is liable to a low flat rate, equal or close to the first bracket rate. However, dividend income reflecting excess returns is regarded as a third tax base, which is liable to a higher flat rate due to double taxation by the corporate income tax and an additional flat tax on excess dividends.

Conceding these facts, the Cnossen proposal should probably be revised, as it appears more likely that European income taxation can be harmonized along the lines of a *triple income tax*. Triple income tax systems of this type seem to generate less political opposition with respect to equity standards. Moreover, they can also be designed to exhibit some favourable neutrality properties,[15] to extend the scope for excess burden reduction, and to allow for a consistent incorporation of income risk in line with optimal taxation models.[16] No revision seems necessary for step 2 although the interest directive of 2003 was a decision against withholding taxes on foreign interest income and in favour of information exchange. But under dual (or triple) income tax regimes withholding taxes will turn out less costly and superior in the long run. Finally, the approximation of corporate income tax rates will continue as a result of tax competition for investment location.

While the perspective for harmonization of personal income tax systems and corporate income tax rates in the EU seems promising, there is still a long way to a harmonized corporate income tax. However, reduced incentives for profit shifting and strategic tax engineering as well as reduced tax collection and control costs within the EU should leave

[15] P.B. Sørensen, Neutral Taxation of Shareholder Income, in: International Tax and Public Finance 12, 2005, pp. 777-801.
[16] D. Schindler, Optimale Besteuerung riskanter Einkünfte. Das Konzept der Triple Income Tax, Mohr-Siebeck, Tübingen, 2006.

sufficient room for discussing thoroughly the options for tax base harmonization and tax revenue apportionment within the EU member states, before a final decision on the best EU scenario for coordinated corporate income taxation is made.

Table 1: Tax Rates (in %) in Selected European Countries for 2006

Country	CIT	PIT on dividends	Integration below NRR	Integration above NRRs	PIT on interest	PIT on labour income
DK	28	28/43	DT	DT	38,8-47,9	38,8-47,9
FI	26	28	DT RRA[a]	DT RDB	28	26,5-50
NO	28	28	Exemption RRA	DT	28	28-40
SE	28	30	DT RRA[a]	DT	30	31,6-56,6
AT	25	25	DT	DT	25	38,3-50
BE	34	25	DT	DT	15	26,88-54,25
CZ	24	15	DT	DT	15	12-32
EE	23	0	Exemption	Exemption	0	23
EL	29	0	Exemption	Exemption	10	15-40
FR	33,3	6,8-48,1	DT RDB	DT RDB	16	6,8-48,1
IT	33	12,5	DT	DT	12,5	23,9-44,9
LI	15	15	DT	DT	15	27
NL	28	25	DT	DT	25	34,15-52
PL	19	19	DT	DT	19	19-40
PO	25	20	DT	DT	20	10,5-42
SK	19	0	Exemption	Exemption	19	19
GE 2009	15[b]	25	DT	DT	25	15-42/45

Notes: CIT corporate income tax
PIT personal income tax
NRR normal rate of return
DT double taxation
RRA rate of return allowance
RDB reduced dividend base
a DT for listed companies, RRA for unlisted companies
b 29,83% if local business tax is incorporated

Source: Kesti, J. (ed.) European Tax Handbook 2006, International Bureau of Fiscal Documentation, Amsterdam 2006