Funding the Future

Why we need corporation tax

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One of the questions posed by the House of Lords yesterday was:

Is there a good rationale for the existing system of taxing corporate profits?

I provided the following written answer:

There are five fundamental reasons for charging corporation tax on company profits:

* ***Companies are not tax neutral. They can significantly change where and when tax is due, who pays it and at what rate. For this reason alone it is vital that there is a corporation tax to tackle the worst of the distortions that the mere existence of companies can create in a tax system.***

* ***Corporation tax is efficient when compared to taxing shareholders on the profits companies make. We simply do not know who the shareholders in many companies are, with this being especially true in the case of multinational corporations. Moreover shares are traded frequently: it has been suggested that the average period for holding a share in the USA is now around 20 seconds.[i] Many shareholdings are themselves hidden in other companies and trusts, many of which in turn are in tax havens to hide their true ownership in an attempt to avoid the taxes due if the true ownership was revealed. In combination these facts mean that replacing corporation tax with a tax on shareholders on the income streams they derive from companies would be a recipe for ensuring some of those owners would pay no tax at all. That would be profoundly unjust.***

* ***Corporation tax charges companies for a benefit provided by society. That benefit is limited liability. This is an extraordinary privilege created, for all practical purposes, in the Victorian era, which if put forward as a new idea now would fail all tests of reasonableness. The idea that a single person may, by signing a few pieces of paper, escape responsibility for paying their debts would be absurd but for our familiarity with it. That privilege may have***

benefits but also imposes costs on society, partly from tax lost when tax debts are not paid, and partly from society bearing the cost of failed companies. Nothing better illustrates this than the cost of bailing out the banks in 2008. It could be argued that some of this cost could be recovered by increasing the annual fees charged by most states to the companies that are registered within their domains for the privilege of keeping a company on its official register of companies, but that would be unreasonable: it would be equivalent to a poll tax. The answer comes instead in the form of a tax on profits that compensates society for the costs companies impose on it; costs broadly equivalent to scale and that must, if any system is equitable, be settled based on a company's capacity to pay which profit implies.

* ***Corporation tax is an essential back stop to income tax: if the profits of companies were not taxed there would be considerable incentive for anyone undertaking a trade to incorporate and so either avoid or defer tax on the profits they make. This would, inevitably lead to significant loss of taxation revenue to the Exchequer.***

* ***There is good reason for taxing profit and not, for example, turnover or cash flow. If appropriately measured profit is the best measure of the economic gain resulting from trade and as such is the best guide to the return to capital resulting from its use in a business. There is, admittedly, good argument for saying that at present International Financial Reporting Standards do not appropriately measure profit and that UK GAAP was of considerably more use for this purpose, but that is a secondary consideration that can be resolved. Taxing anything but profit is to tax some factor other than the reward to capital. Cash flow is, for example, arbitrary and exceptionally difficult to identify as a measure for taxation in complex business enterprises (as indicated by the failure of the accountancy profession to ever come up with meaningful or comprehensible funds flow statements for inclusion in financial statements) and also gives rise to enormous difficulty in separating capital and income flows whilst any form of tax on turnover, however disguised, behaves in exactly the same way as VAT for economic purposes: the incidence will almost invariably fall on customers in most cases, the impact will be inflationary and so considerably economically distortive and the one thing that can be guaranteed is that capital will go untaxed.***

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[i] http://www.therealnews.com/t2/index.php?option=com_content&task=view&id=31&Itemid=74&jumival=6000