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ECONOMIC RELATIONS BETWEEN PERSONAL AND CORPORATE INCOME TAX

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Abstract The main goal of this article is to discuss the mutual economic relations between personal and corporate income taxes. The article consists of three parts. The first is an introduction to these taxes and taxation. The second is the analysis in which the objective of the taxation is discussed. This part represents the trends in research on taxation and clarifies the aspects of taxes that should be considered in an optimal tax system construction. These include solutions which stimulate taxpayer behavior, the economically and socially oriented objectives of taxation, and guides needed for tax equalization. The conclusions are focused on the tax rates in personal and corporate income tax and their influence on economic behavior of firms and individuals. The authors show different points of view on tax rate equalization and discuss its consequences.

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Introduction

Income tax is a prototype of personal tax – the tax which reflects the personal ability of the subjects on which it is imposed. For some time income tax was only paid by individuals, as taxation of individual and legal persons was based on the same principles. For example, a company's profits were in France (until 1948 – *impot sur les societes*) and in Great Britain (until 1965 – *corporation tax*) taxed on industrial and trade profits on the same principles as individuals. What only mattered was the fact that the enterprise existed, its legal, collective or individual nature were not taken into account. The forerunner of a corporate income tax (on business profit) was the construction introduced into the American tax system in 1909. It was only in 1920 that the tax systems in Germany and the United States incorporated the modern construction of corporate income tax as a separate form of direct taxation. The form was a classic system of taxing company profits regardless of its designation, with additional taxation on the dividends on the shareholder's level (Messere, 1993). The same income then is double-taxed, firstly as company profit and secondly as the income of an individual. In other European countries this form of taxation developed

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after World War II. The European leader in separate taxation of individuals and companies was France, which introduced a special tax on company profits in 1948. This tax was introduced in Great Britain in 1965 and in Italy in 1974. Other European countries began introducing corporate income tax in the 1960s (Gaudamet & Molinier, 2000, p. 472, 506 – 507).

Currently, apart from the classic form of profit taxation, we have other forms of this tax: a modified system of double taxation *(modified classical system or partial integration system)*, the system that partially exempts dividends from taxation *(single taxation system – dividends exemption system)*, the system of full imputation of dividends *(full imputation system)*, the system of partial imputation of dividends *(partial imputation system)*. The modified system of double taxation consists in taxing profits both on the level of a company and on personal incomes, but in this system shareholders' incomes are taxed with a lowered (reduced) rate deducted at the source. This system is used in 10 European Union member states. Its construction resembles the system of partial imputation, but it uses other mechanisms lowering the final tax. The system of original taxation of dividends consists in taxing the paid dividend only on the company level with the CIT tax, while the dividend paid to shareholders is not subject to any further taxation. This system is used in four EU member states. In reality it is identical with the system of full imputation of dividends, the only differences being in the taxed subject. The system of partial imputation of dividends, a variation of the modified classic system, is used in two EU member states. The system of dull imputation, used in Malta, consists in taxing the dividend for shareholders, which allows its deduction from the tax base for CIT tax. The dividend is taxed within the personal income tax. The system of partial imputation is used in two EU countries. It is one of the most complicated systems of taxing dividends. Initially, company profit, regardless of its allocation, is taxed with CIT tax, and then the dividend obtained by shareholders is reduced by the tax deducted at the source, which is not a final tax. The dividend is included in the tax base for income tax in its gross amount (that is before taxation with deducted tax), then the tax relief is taken into account, usually in the amount of 50% of due CIT tax and tax deducted. This system is a form of double taxation of dividends, however this tax is negligible (Krajewska, 2004).

Personal and corporate income tax

Tax analysis should concentrate on the features which are responsible for personal and corporate income tax separation. The following arguments supported the introduction of a separate corporate income tax:

1) it reduces disruptions concerning the choice of legal form of conducting business activity (companies versus individuals),
2) with reference to companies, it is impossible to use the elements of personalization, that is adjusting its construction to the individual features of a taxpayer,
3) legal persons have better paying capacity, as concentration of capital allows them to extend the size of a venture, to achieve economies of scale and to improve competitive position compared with other business entities run by individuals,
4) legal persons (companies) are not burdened with the transfer of property when the owner dies, which increases their income (tax) capacity (see more on this in: Krajewska, 2004, p. 88 – 89; Messere, 1993, p. 325 – 326).

It should be remembered that the most significant features of income tax are revealed in taxation of individuals. It is a tax which best implements the principle of taxation equity, through the idea of taxation equality and universality, both in the subject and in the object aspect (tax ability to pay).

The income taxation of companies is a controversial issue. In the case of legal persons we cannot refer to "personal paying capacity", they do not have personal needs, they do not have income "for themselves", they are only representatives of individuals (see more in: Lotz, 1931, p. 505; Folders, 1920, p. 427). Even in conditions of tax progression there is no way to justify in the context of the theory of equal sacrifice and softening the effects of indirect tax regression (J. Stiglitz believes that in practically all tax systems the state does not share economic risk with the taxed enterprise. The state participates in profits, not in losses. Therefore taxation of capital incomes without deducting losses lowers the inclination for economic risk, thus negatively influencing economic growth, as risk is an important, though 'invisible' production factor (see more in: Stiglitz, 2004 and next editions)). The capacity to pay tax in the case of legal persons boils down to the economic capacity, assuming that taxation cannot lead to limiting the productivity of tax sources – in the short term it should not limit

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economic development, in the long term – it should be conducive to this development. Therefore the measure of the tax capacity of a legal person is not the income that an individual is left with to satisfy their needs, but the profitability understood as a relation of profit to own capital. Understood in this way the capacity of a legal person to pay tax is firstly related to the variety of legal and organizational forms of conducting economic activity (for example taxation of single enterprises, concerns or holdings) and the purposes of their activity. As J. M. Buchanan writes, "(…) the differentiating feature of all systems of direct taxation can be illustrated with an elementary comparison between taxation of company income and taxation of an individual's income. In the latter, an individual changes their own tax obligation in categories of tax burden by changes to the amount of obtained taxable income. Their own possibilities of such activity mean that their tax burden indirectly depends on the behavior of other taxpayers, who can act analogically. (…) individuals may, to some extent, lower the tax burden per unit of public wealth by deciding to withdraw from investment in an enterprise. The final burden of an individual becomes inter-dependent of the activities of other people making such "investment re-allocations", (Buchanan, 1997, p. 71-72). Analyzing the essence of taxation of legal persons we can notice that the tax burden depends on gathering (accumulating) taxable income by a legal person, not by an individual. In order to directly reduce the tax burden, such a legal person would have to lower its tax base. Therefore, in order to assess its own share, even regardless of its influence on aggregated investments in the legal person sector, an individual must predict how a legal person (as a company) will react to the size of the tax burden. So we can state that there is an additional entity between the tax organ and an individual, an entity that makes decisions. We are then faced with the necessity to make new predictions, reflecting the processes of making decisions by companies (legal persons – 'intermediary' entities), which are connected with most problems of group decision-making, as opposed to individual decision-making (Musgrave & Shoup, 1959, p. 493 – 524).

The differences between taxation of individuals and corporations do not exclude certain common elements, resulting from the fact that we tax revenues obtained by particular entities in a specific time. Particularly we can notice that by analyzing the material and legal construction of income tax, as well as its size and collection. The common features of income tax mostly stem from the object elements of its construction. This is mostly an indirect tax, generally related to liquid income, generated in a particular period of time, and not expended income. The use of this tax (often excessive) in contemporary tax systems as one of the instruments of state interventionism accounts for the fact that income expenditure is beginning to play an important role in its construction (for example by deducting from tax base investment expenditures). We can assume that income tax covers particular inflows obtained by a given entity, minus the costs of obtaining them. The notion of taxable income is very complicated in itself. For the tax definition of income it is important whether its notion should be external in relation to tax law or whether it should be an internal notion of the above-mentioned law. It is important to what extent tax income should reflect its notion in other branches of law (for example civil law), and especially its economic notion. Currently it is widely accepted that tax law is autonomous to other branches of law, as this is the requirement for achieving the goals imposed on it by the lawmakers. Therefore the notion of tax income should be as adopted by the lawmaker, therefore it cannot be an external notion in relation to tax law. It is essential for the lawmakers to base their construction on the economic category of income, which obviously does not exclude its major or minor modification resulting from the assumed goals of taxation (see more in: Mastalski, 1996, p. 45 – 46; Wołowiec, 2008, p. 194-195).

Tax income, as a 'measure' tax adjusted to the economic and social situation of a taxpayer, is a complex legal structure in its nature, as far as material law, its size and collection are concerned. It is a 'real' tax, depending on the results of economic activity of a taxpayer – the course of his/her future economic activities. For implementing the goals imposed by the lawmaker on income tax it is vital to establish, through tax proceedings, the actual course of events and economic activities shaping the taxable incomes, especially in determining 'the real income' and 'the real cost'.

It should be remembered that in the current construction of corporate income tax (CIT), the tax base is the difference between company revenue and costs of obtaining this revenue. The higher the costs, the lower the tax – this evokes however the

irrational behavior of taxpayers. If we assume that additional (ineffective) costs account for 1% of total costs, we obtain the amount of 13 billion zloty. In 2012 Polish companies obtained the revenue of PLN 1,370.2 billion while CIT amounted to PLN 15.6 billion. Turnover tax at the level of around 1% is a 'lesser evil'. It covers all entities and cannot be avoided by any 'bookkeeping tricks' or avoidance via losses. We can say that it is an effective tax, reflecting the principle of tax equity and expanding the tax base. Such a solution generates better effectiveness for a tax system. Of course, it is not a homogenous tax and while taxing costs it may increase the fiscal burden of processing companies (in their case, the value of the used material is taxed several times), while preferring companies providing raw material. It can be assumed that at a low tax rate, at the level of 1%, and the level of material costs ratio (on half the revenue) the injustice scale would be manifested in the differentiation in the range from 0.5 to 1.5%. Such a solution simplifies the system, as the tax will be collected at the moment the revenue is generated, so that control will be limited to establishing whether the company sells its goods accompanied by an invoice or not. This will allow the 'leaning' of tax organs, lowering compliance costs, simplification of taxpayers' tax returns and elimination of the danger of control. Moreover, CIT in its current form is not fiscally effective – it constitutes only 5% of public income, while its collection is very costly.

Nominally, CIT taxation rates depend on: accounting systems and standards used in a particular country, methods of calculating depreciation, number and types of tax reliefs and exemptions, ways of taxing dividends and profits transferred between related companies, and types of costs of obtaining revenue.

Changes implemented all over the world in corporate income taxation have gone towards lowering the real tax rate (both through reducing the level of the tax rate and through tax reliefs and exemptions, mostly of investment nature), as well as the simplifications of legal construction, and are consistent with the theory of taxation and are a result of the analysis of various cases of states applying particular solutions (De Mooij & Nicod`eme, 2007a; De Mooij & Nicod`eme, 2007b; Djurovic–Todorowic, 2002; Cnossen, 2001) (compare for example *Revenue Statistics of OECD Member Countries 1965 – 2012*, OECD, Paris 2013; *Structure of European Union Taxation Systems 1995 – 2012,* European Commission Taxation and Customs Union, EUROSTAT, Luxembourg 2013; *Structures of Taxation Systems in the European Union 1995 – 2012,* Brussels, 2013; *Structures of the taxation systems in the European Union 1995 – 2012,* European Commission, Luxembourg 2013; J. Kesti (Ed.), *European Tax Handbooks 1995- 2012. International Bureau of Fiscal Documentation,* Amsterdam 1995 – 2013. Undoubtedly, lowering CIT is economically justified, due to progressing globalization and tax competition between countries fighting for direct foreign investment (see more in: Davidson, 2007; Neneman & Piwowarski, 2004; Bond & Channels, 2000; Zee, Stotsky & Ley, 2002; Auerbach, 2005; Feldstein, 2008; Djankov, Ganser, Liesh, Ramalho & Shleifer, 2008). We should remember that:

1) capital, as production factor, is extremely mobile, therefore high taxation of mobile production means is not effective from the perspective of budget incomes coming from taxes,
2) internationally, countries competing for direct investment *(green field investment - FDI),* therefore in capital mobility conditions, low effective tax rates may offer an incentive to potential investors (compare for example: Jensen, 2007),
3) in a closed economy, higher real taxation rates reduce the size of savings and the level of investment. In an open economy, in which the economy is supported not only by domestic savings but also by foreign savings, higher CIT rates compared to other countries will discourage *(ceteris paribus)* investment in such countries,
4) in many countries companies have difficult access to capital markets. This results from asymmetric information, which is translated into high demands of banks against loan-takers and relatively high costs of obtaining capital (interest rates),
5) both tax theory and practice confirm that entrepreneurs, mostly through costs of obtaining revenue, effectively reduce the size of demonstrated revenue or income,
6) when reliefs and lower taxes for foreign investors are used, domestic entities should also be able to take advantage of these preferences (equal treatment of domestic and foreign entities) in order to develop and effectively compete with them,
7) the influence of corporate income tax on savings, investment and economic growth depends also (apart from the level of burden) on the choice of one of three methods of financing the investment: (a) financing with own capital (equity), (b) financing with debt (c) financing from re-invested profits (These problems are analyzed in detail in: Auerbach, 2005; Djankov, Ganser, Mc Liesh, Ramalho & Shleifer, 2008; Gordon

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& Dietz, 2006; Auerbach & Hasset, 2006; Auerbach, 1993; Auerbach, 2002, p. 1251-1292; Barro, 1992, p. 407-443; Caselli & Feyrer, 2007, p. 535-568; Desai, Foley & Hines, 2004, p. 2451-2487; Graham, 1996, p. 41-73; Graham, 2007, p. 1075-1129):

a) Companies finance investment from their own capital or through issuing new shares. In the classic system of financing (dividends are double-taxed – both at the company level and at the individual taxpayer's level) the growing capital costs of financing appear, while shareholders pay less for shares and demand higher dividends. This may mean that the final costs of an investment project will be higher than the market interest rate. Thus the high rate of CIT does not favor investment based on own capital.

b) With external sources of finance, CIT does not lower investment outlay, especially when the CIT rate is lower than the PIT rate, and there is a classic model of dividend taxation. High CIT supports debt-financed investment, encouraging companies to use the tax shield in financing investment projects.

c) In a situation where the real level of CIT tax and capital income tax burden is lower than the level of taxation on interest income, this encourages companies to finance investment expenditure with their profits. Low (together with the zero rate) CIT rates encourage re-investment of profits. However, we should remember that even in a situation where total tax on retained profits is higher than taxation of debt-financed investment, companies may apply the principle of financing investment from retained profits, as future dividends may be converted into less taxed capital profits from shares. This means that unfavorable allocation of capital may take place through preference taxation of re-invested profits.

Assuming that in the international tax competition, the attractiveness of a particular tax system, and as a result – location of investment, depends, among other things, on the level of the corporate income tax rate, an alternative for lowering the tax rate is not to tax profits retained in a company (re-invested), where we tax only incomes of a consumption nature ("getting out" of an enterprise). Another interesting solution may be a system of investment reliefs and exemptions. Apart from the level of effective tax rate, another essential factor may be the coherence of tax regulations and their compliance to accounting regulations (coherence of tax and accounting law).

International and Polish experience in using investment tax reliefs allow us to put forward a thesis concerning the relatively low economic effectiveness of such reliefs. Costs measured by lost budget inflows are large, effects – moderate, while the greatest beneficiaries of this solution are tax advisors (see more in: Joumard, 2001, p. 34-34; Joumard, 2002, p. 124-125; Gaetan, 2007 and European Tax Handbooks [from years] 1995 - 2006).

A survey conducted on nearly 2200 European Union companies indicates that the effective average rate of corporate income tax was in 1990-2001 nearly 10% lower than the nominal rate. In spite of similar nominal rates, differences between countries were large. For example, in Austria, Belgium and Portugal, the effective tax rate was nearly half the nominal rate. In Finland, France, the Netherlands, Sweden and Great Britain, tax reliefs only slightly reduced the nominal rate. The most popular reliefs were related to investment (including R&D), reliefs related to creating new jobs (with emphasis on disabled people and regions with structural unemployment), accelerated depreciation, reliefs supporting investment in poorly developed regions and application of varied rates and special exemptions for foreign investment (which means that domestic and foreign entities were not treated equally).

Tax reforms, being an effect of the assessment of effectiveness of solutions applied so far and tax competition for capital, aim at lowering rates and simultaneously eliminating reliefs. As a result of such changes, the tax base is expanded (the shadow economy decreases), which stabilizes budget tax incomes and sometimes (in the longer run) accounts for their growth (see more in: Zee, Stotsky & Ley, 2002; Edwards & De Rugy, 2002; Lanoo, 2002; Messere, 2000).

Apart from the unfavorable influence of tax reliefs and exemptions on budget incomes, we can identify several other arguments in favor of eliminating various investment preferences from the corporate income tax system. For example, differentiation of tax rates is based on the premises related to creating investment incentives. However, it makes the system complicated and is not certain to bring the planned effect in the form of stimulated investment demand, while generating all kinds of ineffectiveness. The subject literature distinguishes and assesses the effectiveness of the following tools used within the corporate income tax (see more in: Zee, Stotsky & Ley, 2002; Djankov, Ganser, Mc Liesh, Ramalho & Shleifer, 2008; Fletcher, 2002; Chalk & Nigel, 2001).

Table 1: Instruments (preferences) used in the construction of corporate income tax

Type of instrument/preference[4]	*Disadvantages*	*Advantages*
Lowered rate	• large amounts of tax savings go to companies which, even if there was not a lower rate, could enter a given market. The lowered rate allows them to generate extraordinary profits. • allows the use of transfer prices between companies with high and low rates, both in the country and between countries.	• simple to administer. • possible transparent assessment of costs to the budget.
Tax holidays	• may attract short-term investment, • there is a tendency for prolonging the period of tax holidays by creative presentation of an existing investment as a new one, • they create unfair competition between new and old companies. • costs to the budget are less transparent (more difficult to assess) than in the case of a lower income tax rate.	• simple to administer. • limits contacts with tax (treasury) administration.
Investment allowances and tax credits	• favors capital (investment) goods with a short life-span, if allowances are granted for a specific good. • may provoke abuse related to selling and buying the same goods in order to enjoy tax benefits several times. • large administrative costs related to use and control of the granted preferences. • discrimination of an investment with a long return period.	• Offers the possibility of directing investment incentives on types of activities. • possible transparent assessment of costs to the budget.
Accelerated depreciation[5]	• considerable administrative costs.	• causes 're-qualifying' of income tax into some kind of consumption task. • does not discriminate between long-term and short-term capital goods. • in its essence contains all benefits of investment allowances and tax credits.
Stability premiums	• difficult to implement (changeable political conditions), • administrative costs.	• guarantees excluding a given investor or investment from potential future changes in the tax system

Source: Own elaboration

1 For example in the 1990s, in Central and Eastern European countries, the following types and numbers of instruments supporting foreign investment were used: tax holidays – 19, duty exemptions – 13, duty withdrawal – 12, accelerated depreciation of fixed assets – 6, excluding investment from taxation – 3. See: Leibfritz, W. (1997). Taxation and Economic Performance. *Economics Department Working Papers,* Paris: OECD, p. 24.

2 Detailed information on definition, used systems and methods of depreciation in OECD countries: *Tax Profit in a Global Economy,* OECD, Paris, 1991, also: European Tax Handbooks [years] 1995 – 2012, J. Kesti (Ed.), International Bureau of Fiscal Documentation, IBDF, Amsterdam 1996 – 20013 (various years).

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Conclusions

Summing up, we should be cautious when using investment stimulating tools. First of all, the use of general tools, although a simple and cheap solution, does not necessarily lead to the planned effect. Specific tools, on the other hand, are costly, may lead to abuse, and cause ineffectiveness. Economic theory shows that most reliefs very often stimulate taxpayer behavior that is economically and socially irrational (investment) by supporting creation of the so-called tax shields.

If we cannot avoid introducing stimuli to the system, the best solution seems to be directing the size of depreciation (amortization) [3]. The size of depreciation write-off is the part of company profit to which investors or shareholders cannot have any claims. The larger the part of profit that can be used for re-creation and future investment, the better for the potential company development. This factor is of particular importance in the case of high inflation and high costs of acquiring capital for financing investment. In practice there are many possibilities of applying the principles of shaping depreciation, thus affecting the level of costs and amount of profit and tax burden. These are helped by:

1) methods of calculating depreciation,
2) the amortization period of fixed assets,
3) investment deductions beneficial for generating costs,
4) determining the base for valuation of assets that are depreciated and methods of their assessment,
5) negotiable methods of amortization write-offs.

A vital problem appearing in the income tax system is the relation between the height of corporate income tax rate and the rate(s) of personal income tax, taking into account the behavior of taxpayers and influence on the effectiveness of entrepreneurs.

It is believed that different rates in both income taxes may account for transfers of subjects between various legal forms of company activity[4]. From this point of view, equal rates for the above types of tax are a good solution. An opposite conclusion can be reached in model considerations of a capital market in which there is asymmetric information between investors and companies. In this case it is effective and optimal to use a corporate income tax rate lower than the personal income tax rate[5]. This conclusion is even more interesting as this solution is widely used[6]. The differentiation of rates results from the way investments are financed. A lower rate of corporate income tax (lower than the highest rate of personal income tax) is connected with investment from generated profit, which gives possibilities of generating additional financial resources, visible especially in large companies financing their activities in the capital market. Even so, for small companies this factor is also important as increasing the ability to accumulate financial means by any company is always beneficial, especially in a situation when costs of attracting capital are high. In the case of progressive personal income tax, used mostly by households, the above argumentation cannot be applied. Lowering all rates of personal income tax only due to rare business entities taxed along the scale will not stimulate investment while being detrimental to budget incomes. Therefore it seems justified and rational to exclude companies from the possibility of applying personal income tax.

3 Polish accounting standards do not differentiate between amortization and depreciation. GAAP standards distinguish between amortization of non-tangible and legal interests and depreciation of material assets.

4 The existence of simplified forms of taxation and transfer between them and personal income tax conducted by economic entities is not seen as a bad solution.

5 Leveling CIT and PIT rates should also be classified as such a solution, especially when we have a progressive system of personal income tax. See: Fuest, C., Huber, B., Nielsen S. B. (2003). Why is the Corporate Tax Rate Lower than the Personal Tax Rate? The Role of New Firms. Journal of Public Economics, No 1.

6 Most European countries use such a solution. There is no tax system in any OECD or EU country in which the highest rate of personal income tax would be lower than the highest rate of corporate income tax.

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