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University of the Witwatersrand

Faculty of Commerce, Law and Management

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INTEGRATION OF CORPORATE AND INDIVIDUAL INCOME TAXES: AN EQUITY JUSTIFICATION

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ABSTRACT

This paper examines how equity is attained in the realm of corporate taxation. The paper begins by asserting that equity is one of the most important considerations in tax policy design. With this established, the mechanisms for realising equity are examined, being the benefit and ability-to-pay principles. It is shown that these theories can only be applied to individuals and not companies. As such, integration is essential if equity is to be attained. This latter point is further substantiated when one probes the true nature of the corporation; the theory of the firm is explored in terms of contractual theory and entity theory where it is shown that the corporation is nothing more than a 'legal fiction' and thus cannot be a taxable unit. The distortionary and inequitable consequences of a non-integrated system are examined and how integration mitigates this. Lastly, methods of integration, both full and partial, are suggested.

Key Words: Ability-to-Pay Theory, Artificial Entity Theory, Benefit Principle, Contractual Theory, Corporate Income Taxes, Entity Theory, Equal Sacrifice, Equity, Full Integration, Integration, Managerialism, Minimum Sacrifice, Partial Integration, Personal Income Taxes, Progressivity, Proportionality, Rate Structure, Real Entity Theory, Regressivity, Theory of the Firm.

DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

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Jonathan Friedland

28 July 2010

TABLE OF CONTENTS

Chapter 1 – Introduction 1

Chapter 2 – The Need for Equity in Taxation 5

Chapter 3 – The Benefit Principle 9

Chapter 4 – The Ability-to-Pay Principle 13

Introduction: The Concept and its Origins 13
What Constitutes Ability? 14
The Equal Sacrifice Theory 16
The Minimum Sacrifice Theory 18
Conclusion 20

Chapter 5 – The Equity Standard of Levying Taxes 22

Chapter 6 – Application of Benefit and Ability-to-Pay Principles to Corporations . 27

Introduction 27
The Benefit Principle 28
The Ability-to-Pay Theory 32
Conclusion 33

Chapter 7 – Contractual Theory 35

Introduction 35
The Contractual Theory 35
Conclusion 41

Chapter 8 – Entity Theory 43

Introduction 43
The Entity Theory 43
Conclusion 49

Chapter 9 – The Effects of Non-Integration 50

Chapter 10 – Methods of Integration 61

Introduction 61
Full Integration 62
Partial Integration 69

Tax Shifting 71
Other Implications of Integration 72
Conclusion 74
Chapter 11 – Conclusion 76
Appendix 1 – Graphical Representation of Tax Rate Structures 79
References 82

Chapter 1 – Introduction

Taxation, some economists submit, is 'the most important subject to which principles of political economy should be applied' (Dome, 1997:292) and the role of equity therein has been a prominent issue in the economic and political landscape for hundreds of years. Inequitable tax has been central to many revolts and despite its long history the topic has certainly not lost any of its momentum. It is a highly politicised issue in contemporary times and can be a key feature in determining the outcome of elections. As such, functioning democratic governments 'desire to raise such revenue equitably and fairly' (Bird and Zolt, 2003:5). It has thus become necessary to research such a topic to ensure its correct application in the formulation of current and future legislation. As John Stuart Mill (1848:156) declared:

> 'Equality of taxation, requires to be more fully examined, being a thing often imperfectly understood, and on which many false notions have become to a certain degree accredited …For what reason ought equality to be the rule in matters of taxation? For the reason that it ought to be so in all affairs of government'.

The aim, therefore, of this paper is justify the integration of corporate and individual income taxes on grounds of equity. Integration is where corporate profits are vested in the shareholders so that it can be taxed in their hands and not at the corporate level. Integration, in its purest form, ensures all taxes are borne by individuals and not companies. This paper demonstrates that such a regime represents the most equitable method of taxation of corporate profits.

Equity and integration are described by some tax theorists as 'perhaps the hardest problem for the income tax' (Groves, 1974:83). It is interesting, therefore, to note that despite its difficulty and importance, equity is seldom cited in the debate whether the corporate income tax should be abolished. The focus largely centres on the various economic distortions resulting from corporate taxation. For instance, in one of the more extensive analyses of integration, conducted by the United States Treasury Department (1992), equity considerations were noticeably absent. Similarly, in South Africa, the *Commission of Inquiry into the Tax Structure of the Republic of South Africa* (hereafter referred to as the Margo Report) (1986) also made no mention of fairness when considering integration which went

unchallenged by the *Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa* (hereafter referred to as the Katz Commission) (1994). Even historically, as shown by Avi-Yonah (2004), equity is at best a secondary concern, if mentioned at all, in the deliberation of company taxation which has seldom been motivated on grounds of fairness. These are but a few examples.

This is not to say that equity considerations are absent in governmental analyses, like that of the Margo Report and Katz Commission, as well as the various policy briefs by organisations such as the World Bank. On the contrary, equity and issues of fairness are extensively deliberated. The shortcoming is that it is often done *in vacuo* or with reference to personal income taxes and not corporate taxation. There is a noticeable tendency to judge corporate taxation against other criteria without reference as to whether those equity values, that have been analysed, are present.

Accordingly, the purpose of this paper is to bring equity squarely into the debate surrounding corporate taxation. As alluded to in the above quote by Mill, and as further motivated in Chapter 2, equity is in many respects the single most important factor in tax policy design. Whilst this is asserted, it is nevertheless recognised that equity is not the only factor. Other considerations, such as administrative feasibility and collection costs, might be relevant that in aggregate justify a deviation from the equity standard. This is a policy judgement for the incumbent government. The purpose here is rather to establish a system of corporate taxation which is predicated purely on equity thus allowing the policymaker to gauge the costs in fairness of any such deviations from this ideal. As long as one is unaware of what an equitable system looks like, one is unable to measure the cost of these deviations.

With this in mind, the first point of departure, in Chapter 2, is to establish why there is a need for equity in taxation and why it is a crucial component in tax policy design. This chapter will provide more detailed motivation for the research in asserting that the credibility of the entire tax system often rests on equity considerations. The argument lends credence to the many theories and principles tendered over the years and the substantial discussion of the topic in governmental reports, both in South Africa and internationally.

Chapters 3 and 4 present the benefit theory and ability-to-pay principle respectively. These are two suggested mechanisms in realising equity in the levying of taxes. The ultimate

purpose of these models (and the chapters to which they relate) is to develop a tax policy and rate structure that ensures equity in the collection of taxes.

The principles advanced in the above two chapters present a myriad of positive and negative elements and therefore Chapter 5 seeks to parallel the two in making a final determination as to which is more appropriate and practical in attaining the canon of justice in taxation. The product of the research thus far is an equity paradigm for the levying of taxes against which other systems can be judged.

It should be emphasised at the outset that the theories of equality of taxation (being the benefit and ability-to-pay principles) can only be applied to individuals and not companies, or any other inanimate object. It is for this reason that, if equity is to be realised, integration is vital as it places the tax burden on natural persons and not on corporations. Chapter 6 demonstrates this explicitly and shows that it is tenuous and illogical to apply the benefit and ability-to-pay principles to anything but individuals.

Chapters 7 and 8 present a more robust and theoretically rigorous exposition as to why juristic persons are not appropriate taxable units and thus cement the case for integration. In order to show this, the true nature of the corporation is explored in terms of its economic reality and not its legal construction. This then, is the theory of the firm. Chapter 7 examines one such theory, being the contractual theory whilst Chapter 8 presents another, being the real entity theory. These theories draw heavily from economics and jurisprudence.

With the equity standard established, together with the case for integration, a picture emerges as to what an equitable corporate income tax system should look like. Chapter 9 thus demonstrates, from a practical perspective, the unfair and regressive nature of South Africa's current system which goes to reinforce the argument made thus far in the paper.

Chapter 10 presents the various types of integration techniques. Both full and partial integration is explored and the consequences of each for equity. The political constraints that may hinder the implementation of an integrated system are also discussed. Chapter 11 concludes the paper and presents an overview of its findings.

Owing to the topic's importance, the role of equity in taxation has been extensively deliberated by some of the greatest minds in economics such as Adam Smith, John Stuart Mill and more recently Milton Friedman and Richard Musgrave. A literature review of the above authors, amongst many others, was undertaken in establishing the principles governing equity in taxation. Due to the nebulous nature of the subject matter combined with the ever changing economic and political milieu, it is required to be constantly reviewed for correct application and understanding. Such is the purpose of this paper – to scrutinise corporate taxation through the lens of equity.

Chapter 2 – The Need for Equity in Taxation

The purpose of this chapter is to present the reasons why equity is a vital and pervasive consideration in tax policy design. It will be shown that the need for equity is a consequence of three factors. Firstly, equity is necessary in the democratic process. Secondly, equity can actually facilitate government to generate greater revenue. Thirdly, from an historical perspective, equity has proven itself essential to governments' and societies' well-being. In dealing with equity in taxation it is also helpful to distinguish between real and perceived equity; this distinction will also be discussed.

'Equality is foundational to democracy, because it follows from the very definition of democracy' (Post, 2006:7) thus citizens of a democratic state expect equality in legislation. With this as a backdrop, the success of a tax system depends to a large extent on its fairness (Katz, 1995:4). With South Africa's transition to democracy, equity in tax policy became a focal point. As the Katz Commission (1994:7) identified, 'South Africa has adopted a Constitution which insists on equality'. Further still, the Commission (1994:9) noted that 'the tax system is subject to the Constitution…the system should be effective in the enforcement of all tax laws equally'. The Commission therefore ventured as far as to include equity in its 'guidelines of principle' (Katz Commission, 1994:8). The Constitution entrenched the need for equity in taxation as a matter of law.

The Margo Report (1986:37) made note that a widespread belief that the system is inequitable undermines the ability of government to generate revenue due to taxpayer resistance and increased evasion. From this perspective, maintaining an equitable tax policy is in governments' interests. This was articulated in the 1984 United States (US) tax reform programme; 'inequity of the tax system undermines taxpayer morale – a valuable, yet fragile, national asset and a prerequisite for a tax system based on voluntary compliance' (cited in the Margo Report, 1986:3). A public opinion survey in the US confirmed this sentiment empirically, 'that many taxpayers fail to comply because they believe inequities in the tax structure' (US Treasury, 1984:89). Equity thus ensures Jean-Baptiste Colbert's view that 'taxation is the art of plucking the goose so as to get the largest possible amount of feathers with the least possible squealing' (cited in Bradford and Rosen, 1975:2).

The need for equity in taxation is best demonstrated by the socio-political consequences should it be neglected. History has provided us with some enlightening case studies, after all, as Oliver Wendall Holmes remarked, 'A page of history is worth a volume of logic' (cited in Adams, 1995:3). Montesquieu asserted that excessive or inequitable taxes were 'extraordinary means of oppression' (cited in Adams, 1995:6); human nature rebels against such taxation (Adams, 1995:6).

The paradigmatic case is the French Revolution in which taxation was an 'all-important' (Adams, 1999:xxiii) catalyst. 'The tax objective of the state – "what the traffic would bear" – was the amount of tax that could be extracted one step short of causing a major revolt. The government, of course, misjudged' (Adams, 1999:231). Further still, the 'extraction' was from the peasantry, those most unable to pay, whilst the noblemen and clergy were exempt. As the attorney general at the time of Louis XIV stated:

> 'The country has been ruined, the peasants reduced to sleeping on straw, their furniture sold to pay taxes; so that to maintain luxury in Paris, millions of innocent persons…owing but their souls, because no means has been devised to sell these at auction' (cited in Adams, 1999:234).

One statistic on the above matter reveals that 'tax for those who paid amounted to 81 percent of their income' (Groves, 1974:13). It was regressive[1] taxation of the worst kind. On the eve of the French Revolution, when Louis XVI came to the throne, it became clear to his subjects that the only means of achieving equitable tax reform was through revolution (Adams, 1999:236). To say that the reform was violent is an understatement; in many respects it was targeted directly at the revenue authorities, as Charles Adams (1995:4) bluntly conveyed, 'angry over-taxed Frenchmen hauled every tax man they could find down to the guillotine'. The monarch was subsequently overthrown.

Whilst the events of the French Revolution makes one of the strongest cases for equity in taxation, other major historical episodes also go to support this view, such as the American

[1] There are three possible tax rate structures. A flat tax refers to a single rate for all incomes. Progressivity (or progressive taxation) is where the tax rate increase as income increases. Regressivity (or regressive taxation) is where the tax rate declines as income rises. This is depicted graphically in Appendix 1.

Revolution, where the slogan ‘no taxation without representation’ (cited in Ross, 2004:229) was coined, as well as the numerous tax issues arising in Russian, Swiss, Spanish and German history dealing with revolts (Adams, 1999:167). In the United Kingdom, the revolt by the Barons, the English Civil War and the Great Excise Tax Revolt were all ‘tax inspired’ (Vivian, 2006:81). Even today equity elicits fierce debate, like in the case of George W. Bush’s tax reforms which some believe only favour the rich (Greenstein *et al,* 2005:1). As Adams (1995:4) correctly points out, ‘History has not been kind to governments that taxed too much, or in ways that people disliked’. The need for equity in taxation, as history verifies, can be a matter of survival for the incumbent regime.

When discussing the need for equity in taxation, one is obliged to draw the distinction between real and perceived equity. This distinction is largely due to the concept of tax incidence (Begg *et al,* 2003:51).

Formal incidence refers to the individual who is legally obliged to pay the tax; effective incidence refers to the individual who actually bears the tax burden. A particular tax therefore may be paid by one individual but in fact incurred by another. This most commonly occurs in relation to sales transactions where if there is a particular good that is in high demand with few substitutes, an increase in taxes is just passed on to the consumer in the form of a higher price. The seller assumes the formal incidence and the consumer, who now pays more for the good, the effective incidence. Incidence can also influence personal income tax (albeit not as explicitly), for example, if a particular type of labour is in high demand, an increase in personal income tax rates may result in the employer incurring the additional tax, in the form of a higher wage, so as to leave the after tax income unchanged. The employee assumes the formal incidence and the employer the effective incidence (Margo Report, 1986:52). ‘It is difficult to comment on this effect, which will probably be more pronounced where trade unions are active’ (Trotter, 1969:326).

Therefore, in such cases, whilst actual equity is usually affected by a tax policy change, perceived equity is not necessarily so. Therefore if government aims to avoid a degeneration of tax morality and the attendant deleterious effects as mentioned above, perceived equity becomes increasingly important even though it does not represent the economic reality (Margo Report, 1986:52).

The need for equity in taxation is of undeniable necessity, not only as a result of South Africa's constitution but also, as history affirms, it reduces political friction and social unrest. Furthermore, it serves government's interests in generating its desired level of revenue by enhancing taxpayer co-operation. Equity is not a variable that treasuries can afford to neglect.

Now that this has been established, the next step is to determine how equity can be attained. With this objective, an analysis of 'the two great traditions in the theory of taxation' (Margo Report, 1986:50), being the benefit principle and the ability-to-pay principle, will be assessed. These principles aim to develop a tax policy that will secure equity.

Chapter 3 – The Benefit Principle

The benefit principle, as a mode of equitable taxation, attempts to replicate free market mechanisms in that tax is levied in accordance with the benefits received by the taxpayer (Rothbard, 1970:114). It is the concept that individuals should return to government, by way of taxes, based on what they received from it (Groves, 1974:29). Unlike the ability-to-pay and its variants, the sacrifice principles (see next chapter), the criterion for payment is benefit rather than sacrifice (Rothbard, 1970:114).[2] Also, unlike the latter, fairness is extended to the expenditure side as well as taxation, something that has been emphasised in the formulation of tax policy (Bird and Zolt, 2003:17 & Slemrod, 1994:342).

Since Adam Smith's seminal treatise *An Inquiry into the Nature and Causes of the Wealth of Nations* (*The Wealth of Nations*) (1776), the benefit principle was ubiquitous in tax literature dealing with equity (Groves, 1974:29). This is not so much as a result of Smith's equity maxim *per se* (which in many respects is ambiguous as to whether he favours this principle or the ability-to-pay principle) but rather due to the notion of the *invisible hand*, that is, in the individual's pursuit of self-interest, the allocation of resources, as if led by an invisible hand, yields an outcome that is not only efficient but just. Thus a tax system predicated on such free market values was considered necessarily equitable. The capitalist would philosophically be inclined to favour this basis of taxation (Rothbard, 1970:115 & Slemrod, 1994:343).

The benefit principle exists over a spectrum. At the one end, it manifests itself as *user charging,* which requires that where a definite *quid pro quo* is identified, a specific charge should be levied for its use. Obvious examples are toll roads and entrance fees to public museums. As regards the former, the benefit of government expenditure to the individual is the use of the road and, as such, the toll is the tax for this benefit. The principle functions effectively at this level and it has advantages in that it prevents the squandering of public resources and promotes efficient use of tax revenue from the government's perspective (Margo Report, 1986:51).

[2] These theories of achieving equity in taxation are individual orientated; that is they apply to natural persons and thus emphasise the need for integration if they are to be realised. Nonetheless, explicit attempt to apply them to juristic entities is done in chapter six. For these chapters, the original formulation in terms of individuals is retained.

As one moves away from this point, so the benefit principle becomes less operative, but nevertheless still applicable. A *quid pro quo* may not be identifiable but may be reasonably estimated. For instance, street cleaning expenditure can be funded by a tax on the basis of a participation quota of road frontage (Slemrod, 1994:343).

At the other end of the spectrum the principle breaks down and is no longer useful because certain public costs are not rationally divisible, for example, how can the benefits of defence expenditure be allocated to a particular individual (Slemrod, 1994:2)? Despite the fact that the application of the principle becomes nonsensical, there have been various methods advanced for such an allocation (Rothbard, 1970:114). Some economists, such as Musgrave, advocate apportioning this indivisible expenditure on a per person basis. If this is accepted, then we are to assume that a rich man with four dependents receives five times as much from government than a single poor man on welfare. This is highly questionable to say the least (Groves, 1974:31).

Other writers believe that the income of the individual should be used as a basis for determining his benefits, and by extension the amount of his tax liability. The higher the individual's income, the greater the benefits he is assumed to receive and thus the more tax he should pay. This assertion is tenuous for two reasons. Firstly, a particular individual may have a greater income than another, not because he enjoys more benefits from government than others, but rather because of his value to society. However, society is not the state; the latter's claim to tax has to be independently validated. Secondly, benefit taxation on income implies that the rich reap greater benefit from government expenditure than do the poor. Under a welfare state this is clearly untrue. Benefit taxation on income, therefore, is incompatible with equity (Rothbard, 1970:115).

The benefit principle however can be effectively applied based on an individual's consumption. The outcome of this is indirect taxes such as Value-Added Tax (VAT) (Margo Report, 1986:70). Generally, taxes on consumption do have a philosophical foundation in equity. This was most aptly conveyed by Thomas Hobbes (cited in Groves, 1974:14):

> 'The equality of imposition consisteth rather in the quality of that which is consumed…For what reason is there, that he which laboureth much and sparing the fruits of his labour, consumeth little, shall be more charged, that he who liveth idly, getteth little, and spendeth all he gets'.[3]

The Margo Report (1986:70) makes clear that the degree of indirect taxes, and by extension the application of the benefit principle, depends upon the socio-economic conditions of a particular economy. The Katz Commission (1994:12) defined this as the more homogenous the society is in its distribution of wealth the more acceptable and equitable it would be to place greater reliance on indirect taxes, which are regressive in nature. It is regressive because the payment of VAT impacts more lightly relative to income as income rises (Katz Commission, 1994:112).

The likes of Hobbes, and others who echo his sentiments such as Sir William Petty, stressed consumption taxes on luxuries rather than necessities so as to negate this regressivity and the bias against the poor where there is a skewed distribution of wealth (Groves, 1974:14). Principally, on these grounds, many countries have adopted a multiple rate structure of VAT, including South Africa where the zero rating applies (Katz Commission, 1994:110). This does enhance equity but in so doing presents other problems; as voiced by Tait (cited in the Katz Commission, 1994:116), 'The worst of all worlds is to end up with an eroded VAT base, complicated rates and exemptions, and a tax that is expensive to administer, all in the name of equity'. Tait suggests rather sacrificing equity on the revenue generating side (i.e. a single VAT rate) and then compensating on the expenditure side with greater government subsidies. It is noted that political pressures often crowd out these economic arguments (Katz Commission, 1994:117).

A severe shortcoming of the benefit theory is that it neglects any form of vertical equity. Vertical equity (as applied to taxation) is the concept that different income groups should be taxed differently in order to mitigate these innate income disparities (Begg *et al,* 2003:213). Essentially, it is concerned with the redistribution of income. Because, by definition, the benefit principle only taxes (or attempts to tax) the *quid pro quo* of government expenditure, vertical equity cannot be applied, the tax being independent of the individuals income. As a matter of equity in tax policy design, if the main objective is vertical equity, then the benefit

[3] It is submitted that this application is still deficient in that it taxes the benefits the individual receives from society (via his consumption) as opposed to the state.

theory is clearly inappropriate (Begg *et al*, 2003:234). This is certainly the case in South Africa where there is widespread income inequality (Katz Commission, 1994:3). This was a fundamental consideration for tax reform under the Katz Commission (1994:3) and as such was recommended that distributional objectives are better served by income tax progressivity rather than VAT (Katz Commission, 1994:119). Theoretically however, benefit taxation can satisfy vertical equity under only one condition, and that is if it is applied to an already existing equal state of distribution. Knut Wicksell therefore believed that equality in tax could be achieved by first adjusting the distribution of income and then applying benefit taxation (Slemrod, 1994:344).

It is also interesting to note that the benefit principle as a theoretical hypothesis suffers from some inherent flaws. Firstly, if one is taxed on the benefits received from government, it would necessarily mean that the full income of public servants would be subject to tax whereas the same function performed in the private sector would not (Rothbard, 1970:116). Secondly, it would require recipients of welfare to be taxed on the benefit received; this would undermine the very concept of welfare in the first place (Begg *et al*, 2003:235).

There is still a further theoretical anomaly. As mentioned above, the basis for gauging the equality of the benefit rule is its parallel functioning to the free market where the latter is synonymous with equity (Slemrod, 1994:343). However, if the principle is scrutinized further, a strict application reveals that it does not yield total market neutrality. In theory, each individual pays taxes based on the benefits that they receive. This would mean that taxes for the same government service would differ amongst individuals (or groups of individuals) according to their own particular benefit. But this is not how the market functions. Under market conditions, all consumers pay the same price for a particular service as determined by supply and demand considerations and not benefit. A differing tax is therefore not a reflection of free market mechanisms. Consequently, if it is no longer functioning similarly to the market, the conclusion of fairness may not be entirely valid (Rothbard, 1970:116).

In summation, the benefit theory of taxation is largely grounded in capitalist free market ideals however the concept as a discrete theory does suffer from certain aberrations and anomalies. Despite this however, it does have a practical application in the form of consumption and *user charging*. In reality, its most significant drawbacks are that it cannot be applied to indivisible government services and neglects vertical equity.

Chapter 4 – The Ability-to-Pay Principle

Introduction: The Concept and its Origins

The ability-to-pay principle disregards any type of expenditure benefits of government services and instead calls for the tax burden to be distributed on a fair basis. As the name suggests, fairness is considered to be the individual's ability to pay. The underlying idea is that tax is a sacrifice levied upon some kind of personal economic well-being (Margo Report, 1986:50 & Slemrod, 1994:344).

The theory is premised on achieving both horizontal and vertical equity. The former is the identical taxation of people in identical situations. Thus people with equal ability to pay will assume the same tax liability. Vertical equity, as defined in the previous chapter, is also secured in that those taxpayers with a greater ability to pay will pay more (Begg *et al*, 2003:213 & Slemrod, 1994:344).

The concept of ability-to-pay was identified as early back as Smith (1776:825) when he declared in his first maxim of equity that 'the subjects of every state ought contribute…in proportion to their respective abilities'. However, Smith gave no philosophical grounding in equity to support this view (Rothbard, 1970:109). One, therefore, has to turn to Mill (1848:157) when he stated:

> 'As, in the case of voluntary subscription for a purpose in which all are interested, all are thought to have done their part fairly when each has contributed according to his means, that is, has made an equal sacrifice for the common object; in like manner should this be the principle of compulsory contributions'.

Many find a basic attraction to assessing tax in this manner (Bird and Zolt, 2003:16), so much so, that even the Margo Report (1986:50) recognised that 'almost everyone subscribes to the ideal of taxation in accordance with the ability to pay.' This does not mean however that it is free from criticism on theoretical grounds. Murray Rothbard (1970:110) indicates that if this principal is to be judged against free market ideals then there is no basis for adopting the

theory as it is centred around 'socialist distribution' (Groves, 1974:28) and certainly rings of the Marxist slogan of 'From each according to his ability' (cited in Fair, 1971:1).

Despite its universal acceptance and application, the concept creates difficulties that stem from the conventions that must be accepted when making the transition from the theoretical notion, as described above, to the exact definition and nature of tax policy. In this respect, the problematic issues concern the interplay between the taxpayer's ability to pay, the definition of sacrifice and the progressivity or proportionality of the resulting tax rate structure (Margo Report, 1986:50 & Groves, 1974:33). These issues will now be addressed.

What Constitutes Ability?

The question must be posed as to how an individual's ability to pay is determined. Various measures have been contemplated. The Margo Report (1986:50) suggested three possible bases: income, expenditure and accumulated wealth.

At present, South Africa, along with many other countries around the world, considers annual income to reflect the most appropriate indicator of a person's ability to pay and therefore income taxation complies with the equity norm (Margo Report, 1986:71).

Others, however, hold the view that annual income is too short a period with too much volatility to be used to gauge the person's ability (Bird and Zolt, 2003:16). Rather, what is proposed is lifetime income. This takes a long term approach in measuring one's ability to pay and in so doing enhances equity. Due to the indeterminability of lifetime income, the next step was then to ascertain an appropriate proxy for it. With this goal, tax theorists turn to Friedman's Permanent Income Hypothesis which states that expenditure reflects long-run (or permanent) income. The rationale of this hypothesis is as follows: Suppose a particular person believes current annual income to be excessively high; since this makes little difference to permanent income, or the expenditure that can be incurred in the long term, the person hardly increases current consumption but rather saves the money for years when annual income will be unusually low. Conversely, if people believe (or know) that the increased annual income will be sustained, so their expenditure will rise. As such, advocates

of this concept believe expenditure tax is more of an equitable base than income tax (Begg *et al*, 2003:334 & Margo Report, 1986:73).

Accumulated wealth can also be taken into account in judging ability to pay. Proponents of this view submit that wealth provides a good measure because assets 'imply some degree of tax capacity even if they generate no tangible income' (Britannica Online, 2007). For example, for two individuals who earn the same annual income, the individual with a greater asset base will also have a greater ability to pay the given tax liability than the other (Rothbard, 1970:107).

Whatever the reasoning of the above bases, the ensuing discussion on the sacrifice theories assumes income as the taxpayer's ability to pay. This is because it is 'so widely used' (Margo Report, 1987:71) and moreover, as Smith (1776:825) correctly observed, all taxes must eventually be paid out of income and as such are, in some sense, income taxes. They differ not in their ultimate source but in the way they tap it, thus property taxes are income taxes measured by property, sales taxes are income taxes measured by purchases and so on (Groves, 1974:24).

As the research problem indicates, this paper is centred on income tax; it is pertinent at this point therefore to discuss more thoroughly the application of income as a tax base. The equity of income tax was enunciated as far back as Mill (1848:183) who described it as 'the most just of all modes of raising revenue'; it is further described as 'the least exceptional of all taxes' (Mill, 1848:182).

Musgrave (1989:3) considered one of the key benefits of income tax is that, being a direct tax, it is highly 'visible' to the taxpayer. This view is consistent with the concept that all taxes are in some sense income taxes. A tax levied on income directly aids the person to gauge more precisely the quantum of taxes paid or payable in the future based on estimated earnings, thus supporting Smith's (1776:826) certainty maxim that taxes should be 'clear and plain to contributor and every other person'. This visibility serves as a constant reminder of the quality of 'public service that should be provided in return, it thus promotes an efficient public sector, unlike "invisible" product taxes such as a value added tax' (Musgrave, 1989:3). It is this very visibility that strengthens the need for equity in taxation, as Friedman (1980:295) confirms, 'Citizens are aware of taxes…and income taxes…are directly and

painfully visible – and they are the taxes on which resentment centers', the greater the inequity of the system so the greater is the resentment.

Despite the fact that income tax is 'regarded as the best and most equitable form of central finance' (Musgrave, 1989:3), it does not mean that the tax authorities ought to rely only on income taxes. In fact, Adams (1995:7) shows that 'if great revenues are needed…then a single tax will become excessive…and foster evasion'. The application of other instruments such as VAT, as indicated in Chapter 3, are not necessarily inequitable 'as they are based on what people "take out" of the economy' (Margo, 1986:73) and their use, as Adams suggests, can be beneficial. Furthermore, multiple tax instruments (which can include, *inter alia*, excise taxes, estate duty and transfer duty) have 'the important advantage of spreading the total tax burden as widely as possible' (Margo, 1986:69). In fact, more instruments 'will enable lower tax rates per instrument for a given revenue envelope' (Grote, 2007:10); in developed countries 95 per cent of the revenue raised is generated from six instruments (Grote, 2007:23). However, it is incumbent upon the tax authorities to address policy from a holistic perspective since 'all taxes amount to fishing in the same stream' (Groves, 1974:24).

It is because 'income tax remains superior to other proven taxes and preferable to most alternatives' (Musgrave, 1989:3) and further still it is the 'equality of the income tax system [that] determines the integrity of the entire tax system' (Vivian, 2006:79) that it is the focus of the ability-to-pay principle and of this paper.

The Equal Sacrifice Theory

Due to its elusive nature, the term 'ability-to-pay' was further defined to encompass the person's ability to make sacrifices (Rothbard, 1970:111). Mill (1848:155) introduced the concept of sacrifice as the key to equity, he stated:

> 'Equality of taxation, therefore, as a maxim of politics, means equality of sacrifice. It means apportioning the contribution of each person towards the expenses of government, so that he shall feel neither more nor less inconvenience from his share of the payment than any other person experiences from his.'

This statement hinges on the concept of 'equality of sacrifice'. In essence, this implies that it is less of a sacrifice for a rich man to pay a given amount than a poor man. Expressed as a general rule, the utility (satisfaction) of a unit of money to an individual diminishes as his wealth increases (Frank, 2003:212). This would suggest that the wealthy should be taxed more than the poor.

The next inquiry is to ascertain the meaning of 'taxed more than'. Does it suggest that the tax of the rich exceed that of the poor in an absolute, proportional or progressive sense? The equal sacrifice theory does not actually provide an answer (Rothbard, 1970:112). In order to make this determination, economists employed the microeconomic technique of the income-utility curve which measures the relationship between income and utility for a particular individual. The more rapidly marginal income declines, the more likely it is that equal sacrifice will yield progressivity (Rothbard, 1970:111 & Frank, 2003:212 & Black, 2007).

The above concept, that initial income is considered more important than subsequent increases, has been given a social twist. S.J. Chapman believed that early increments to income are more important to the individual because that income is spent on necessities of survival whereas later increments are more likely to be applied to luxuries. This point of view supports the case for progressivity as an equitable tax regime as it is better to deprive a rich man of luxuries than a poor man of necessities (Groves, 1974:62).

As the above indicates, economists evolved the theory from the philosophical sphere to a qualitatively mathematical one. Taking it any further in determining a precise tax rate structure was unsuccessful. This is because individuals do not have the same income-utility function and neither are these functions quantifiable – fundamental assumptions in the analysis (Rothbard, 1970:111).[4] This is succinctly expressed by E.R.A. Seligman when he stated 'From the equality-of-sacrifice doctrine of itself we cannot deduce any mathematically exact scale of taxation, whether progressive or anything else' (cited in Groves, 1974:44).

Instead, Seligman attempted to incorporate progressivity in the equal sacrifice principle as a matter of fact. He established the faculty theory which is underpinned by the belief that the

[4] That each individual has a different income-utility function which is unquantifiable means that it is impossible to determine that each person is sacrificing equal amounts (Rothbard, 1970: 112).

more wealth a person has, the easier it is for him to acquire more. If this is so, then the wealthier individual should be taxed at a higher rate than the less wealthy. However the theory suffers from the same immeasurability problems as the income-utility approach. Whilst one does observe that a little success makes further success more easily attainable, this is merely anecdotal. At best, the faculty concept can only present a plausibility argument for progressive taxation (Groves, 1974:44).

Mill (1848:155) most aptly summed-up the position of the equal sacrifice theory when he said:

> 'The standard, like other standards of perfection, cannot be completely realized; but the first object in every practical discussion should be to know what perfection is.'

The Minimum Sacrifice Theory

The equal sacrifice theory, which was of limited use, was assessed on an individual-by-individual basis; an alternative to this was then to rather assess the tax sacrifice from the perspective of society as a singular unit. This manifested itself into the minimum sacrifice principle which states that society, as a whole, should sacrifice the least amount (Rothbard, 1970:111). As Thomas Carver (1904:69) notes, the evils of taxation are sacrifice and repression; society should keep the sum of these as low as possible.

This approach was built largely on the utilitarian philosophy which, simply stated, demands 'the greatest good for the greatest number' Manin *et al*, 1987:344). More specifically, the measure of good governance is 'to promote the greatest happiness of the greatest number of citizens and to effect harmony between public and private interests' (Runes, 1959:251). Policies, including that of tax, should be judged solely by whether they work beneficially on the collective level. If taxes are considered a sacrifice, as the ability-to-pay notion submits, then the disutility of taxes should be reduced to a minimum (Groves, 1974:55). F. Y. Edgeworth, who pioneered the minimum sacrifice theory, attempted to determine the rate structure under utilitarian dogma (Groves, 1974:54).

The minimum sacrifice theory requires an acceptance of the basic premise that the utility of money does diminish as income rises (unlike the equal sacrifice theory, quantification is not

required). This together with the utilitarian notion, as expressed above, indicates an excessive progressive rate structure (Groves, 1974:55). This is best illustrated by way of a simple example:

Suppose that there are two taxpayers, A and B, with respective incomes of R50 000 and R30 000 each. Suppose that the *fiscus* requires R1 in revenue, how should it be generated? The theory states that the minimum social sacrifice is achieved if A is taxed. Now suppose, the *fiscus* requires R2, once again the minimum social burden results if it is taken from A. This process continues until both A and B have equal income. From a macroeconomic viewpoint, this means taxing the highest incomes in turn until governmental needs are satisfied (Rothbard, 1970:112).

Utilitarianism does not have a problem with this strict form of taxation, for it states:

> 'To the view that a person has a natural right to the fruits of his own labour the answer is that he has no right to anything unless it can be established that his possession on balance and in the long run will add more to the well-being of the community than it will detract' (Groves, 1974:56).

This minimum sacrifice theory identifies justice with the greater good for society and then merely inquires what tax institutions work best in terms of their overall outcome. The irony is that, as the above example shows, not much is left of individual equality except the requirement of equal consideration (Groves, 1974:62). Furthermore, the theory neglects the inevitable moral outrage by the wealthy at this tax procedure (Rothbard, 1970:113). As Henry Fox said 'All governments must have a regard not only for what people are *able* to pay, but what they are *willing* to pay' (cited in Adams emphasis in the original, 1995:6). Furthermore, governmental needs are often considered insatiable which would result in a system of total taxation; to avoid this, the minimum sacrifice theory is therefore more appropriate to those jurisdictions[5] which have 'adopted amendments to their constitutions that limit the amount of taxes that the state may impose' (Friedman, 1980:301).

[5] Previously, certain states in the US have legislatively capped the amount of taxes that may be raised (Friedman, 1980:301). This is not to say that the minimum sacrifice theory was adopted in such regions; rather that if it were to be adopted it would be most appropriate in such states.

To critique the minimum sacrifice doctrine is therefore to critique utilitarianism. An oft cited rebuttal is that it 'conflicts with common sense' (Haines, 2006:4). The whole utilitarian philosophy assumes the measurability of the immeasurable and a comparison of the incomparable. After all, it is impossible to define objectively what the correct distribution of satisfaction is (Groves, 1974:57). This extreme taxation will have adverse effects on production and the motives for the individual to work and save (Groves, 1974:55). As specifically mentioned in the Margo Report (1986:103) 'high degrees of progression inevitably…impose a price in terms of economic efficiency'. This is something that tax policy design attempts to avoid (Bird and Zolt, 2003:17).

In the theory's defence, it is worth noting the observations of I.M.D. Little that there is something advantageous in utilitarianism as long as it remains vague and imprecise but it becomes nonsensical if one tries to make it an exact science. It provides a proper approach to public policy questions but gives us no certain or verifiable answers (Groves, 1974:57). Thus, the notion that society should sacrifice the minimum amount can be useful as long as it is tempered by the practical economic effects of the resulting tax policy; such progressivity is counter-productive (Groves, 1974:55).

Conclusion

Owing to the popularity and intuitive appeal of the ability-to-pay principle, its application has been formulated into two separate theories being equal sacrifice and minimum sacrifice; both of which aim to realise horizontal and vertical equity. Whilst various measures, such as expenditure and accumulated wealth, have been proposed in gauging the taxpayer's ability, the income base is most equitable for reasons of visibility and incidence but, above all, it is the recognition that all taxes can only be paid out of income.

The equal sacrifice theory, whilst theoretically sound, does not infer an exact tax rate structure despite the use of marginal analysis and various plausibility arguments in favour of progressivity. The minimum sacrifice theory, premised largely on utilitarianism, substituted the problem of quantification for inordinate progressivity that cannot be applied in a functioning capitalist market; it neglects any practical considerations that would undermine this progressivity.

Despite this however, these concepts and how they are conceptually formulated provide the fundamental framework in judging the consequences of a given tax proposal (Bird and Zolt, 2003:17). They have existed and been developed upon for hundreds of years and are most valuable as a normative[6] tool in tax policy design. If equity is to be achieved, they are an essential consideration. The extensive discussion in the Margo Report, Katz Commission and their counterparts abroad is testimony to its practical importance and relevance.

[6] Normative recommendations are those based on personal value judgements.

Chapter 5 – The Equity Standard of Levying Taxes

The above discussion tendered the two primary theories (the benefit and ability-to-pay) in levying taxes equitably. As indicated, both contain positive and negative aspects. The following analysis now presents the two theories in an effort to determine which one is more suitable and practical in realising equity in the levying of taxes.

Mill's *Principles of Political Economy with Some of Their Applications to Social Philosophy* (*Principles of Political Economy*) (1848) will underlie this discussion for a number of reasons. Firstly, it was a 're-survey [of] the entire field of political economy' (Winch, 1970:26) which mirrored Smith's model of the *Wealth of Nations* in approach. Secondly, being most germane, 'Mill's primary concern was with the problem of equity…Mill clearly felt that it was essential to know what a perfect system should look like' (Winch, 1970:44). Thirdly, his stature is largely unrivalled and many believe him to be 'the greatest public intellectual in British history' (Reeves, 2006:2) and whom, the four times British Prime Minister William Gladstone referred to as 'the saint of rationalism' (cited in Reeves, 2006:1).

In *Principles of Political Economy*, Mill (1848:156) strongly and unambiguously asserts that the benefit principle is nothing more than 'a false air of nice adaptation'. He presents the most compelling argument for its final elimination from the lexicon of public finance.

His pre-eminent argument is against the composition of the principle itself. That the theory would require those most dependent on the state, being the poorest, to pay the most tax (in that they receive the most benefit due to government welfare) is 'the reverse of the true idea of distributive justice' (Mill, 1848:156). This anomaly, in particular, as well as the others mentioned in Chapter 3, renders the theory totally inconsistent with equity.

Mill cements his position in a further attack, premised on a matter of practicality. In this regard, even if one were to accept an application of the theory, he questions 'the practice of setting definite values on things essentially indefinite' (Mill, 1848:156). This relates to the discussion above where suggested methods of determining an individual's benefit from

indivisible government expenditure (for instance, based on income or a per capita basis) has historically proven to be a futile exercise.[7]

Mill's final criticism is against the very basis of 'benefit received from government' in establishing the tax burden. He stated (1848:156):

> 'The ends of government are as comprehensive as those of social union…[it] must be regarded as so pre-eminently a concern of all, that to determine who are the most interested in it is of no real importance'.

Essentially, Mill's argument combined with the other shortcomings mentioned in Chapter 3 must result in a rejection of the theory and thus it should not be employed as a justification by governments in their accumulation of taxes. Furthermore, in the analysis of income taxation, the theory plays no role as it is incompatible with an income base (Musgrave, 1989:11).[8]

It should be noted that these arguments have stood the test of time in that revisionist theory over the principle, most notably by Musgrave, 'has largely been unsuccessful' (Groves, 1974:32). With the firm refutation of the benefit principle, the levying of taxes must then take the form of one of the sacrifice theories.

The adverse effects of the minimum sacrifice theory being disincentives for the individual to work and the moral outrage of the rich at this process combined, above all, with its price in terms of economic efficiency confines the theory, in the stringent formulation as discussed above, to the sidelines of tax policy design (Bird and Zolt, 2003:17). Similarly, the equal sacrifice theory, whilst a convenient theoretical construct, suffers a fatal pitfall in the form of quantification .

[7] It is submitted that the relevance of the principle, in the form of *user charging*, is still appropriate but of such limited application as, by definition, the revenue generated must only go to support that particular service and not of government's other, and more widespread, objectives. These being the facts, it is thus confined to the fringe and serves little purpose in the discussion of taxation in general (Zee, 2005:4).

[8] As indicated in chapter three, it is sometimes applied to a consumption base in the form of VAT, however as mentioned in that chapter, this more represents the individual's benefit from society in terms of his consumption than it does his benefit from government services.

Mill overcomes these hurdles and presents the equal sacrifice theory subject to exact formulation. He advanced that equal sacrifice is achieved via a proportional tax rate structure. If the theory proposes that each taxpayer sacrifice so that they 'feel neither more nor less inconvenience' (Mill, 1848:155), proportionality is far more appropriate. Mill, along with the other economists of the time, was averse to progressivity and could not find any justification for it (Vivian, 2006:87). Mill stated (1848:159) 'To tax the larger incomes at a higher percentage than the smaller, is to…impose a penalty on people for having worked harder and saved more' – graduation of income taxes are 'unjust and impolitic' (Mill cited in Groves, 1974:33)[9].

This approach to proportionality confirms Smith's intention when he first expounded the concept of equity in taxation; his first maxim reads 'in proportion to their respective abilities' (Smith, 1776:825). David Ricardo's support for proportionality stems from his view that an equitable tax is one that is as neutral as possible; proportionality satisfies this criterion, as Ricardo stated (cited in Dome, 2000:238) 'The income tax, were it fairly imposed, would leave every member of the community in the same relative situation in which it found him'.

Mill however makes further refinements to his proportionality view in the name of equity. To apply proportionality over the entire income range would necessarily mean taxing the poor who he objectively defined as those with insufficient income to cover the necessities-of-life. In light of this, Mill (1848:158) proposes 'leaving a certain minimum of income, sufficient to provide the necessitates of life, untaxed'; 'This then should be made the minimum and incomes exceeding it should pay taxes [in proportionality]…upon the surplus'[10] (Mill, 1848:158). Smith also favoured this exemption however Mill's formulation represented a change in motivation from that of Smith's; 'instead of not being able to tax the poor, it now became a case of not wanting to do so' (Groves, 1974:34).

Whether, after this basic exemption, the income-utility relationship holds and to what extent, is no longer relevant as it is not 'capable of being decided with the degree of certainty that a

[9] This counters the plausibility arguments for progressivity as advanced by Chapman and Seligman in chapter four.

[10] Assume therefore that the minimum exemption from tax is R10,000, if a taxpayer earns R15,000 and the flat rate is 10 per cent, then the tax liability would be R500 (R5000 x 10%); not levied on the total amount of R15,000.

legislator of financier ought act' (Mill, 1848:159). If proportionality is accepted then the shortcomings of the utility-theory approach becomes redundant. The only quantification required is the rate to be applied to the income 'and is determined by the revenue requirements of the *fiscus*' (Trotter, 1969:319).

This rate structure is just as valid in contemporary times as endorsed by Friedman (1980:307) in his proposed changes to the American tax legislation:

> 'The congress shall have the power to lay and collect taxes on incomes of [natural] persons…provided that the same tax rate is applied to all income in excess of…a personal allowance of fixed amount'.

This hybrid approach combining rudimentary progressivity in the 'exemption of a minimum' (Groves, 1974:34) and subsequent thereto proportionality over the remainder of the income range is thus a practical benchmark against which equity in taxation can be judged.

In Chapter 4, some motivation was provided for income as the tax base; at this point it is proper to add what Musgrave (1989:3) believed is the most compelling reason for income as the base; and that is, it conforms to this equity standard of the ability-to-pay as established; it permits tax liabilities to be adjusted around this ability.

In South Africa, the normal tax liability of the individual is determined in accordance with a progressive rate regime. However it is not progressivity but proportionality (above the exemption) which ensures equity. Despite its 'shaky theoretical foundation' (Bird and Zolt, 2003:16), the employment of a progressive rate structure is not an aberration in developing countries. To put progressivity into a global context, in 2000 the International Monetary Fund conducted an inquiry which revealed that of the 14 studies conducted amongst certain developing countries, 12 were progressive in relation to income tax (cited in Bird and Zolt, 2003:21).

Progressivity should also be read in context of the socio-economic climate that exists within South Africa. With 'disparities between the wealthy and the poor…amongst the greatest in the world' (Katz Commission, 1994:3), government's income distributional objectives are 'served by a moderate degree of progression of income taxation' (Katz Commission,

1994:119). This is contrasted to a system of proportional taxation, where 'each person…claims the same share of national income after paying taxes as it did before paying them' (Shapiro, 1996:13) – The distributional effects are not as pronounced as proportional tax is more neutral. Therefore, progressivity is considered to better reflect vertical equity in these distributional effects, however as Mill (1848:159) rebutted 'I am as desirous as any one, that means should be taken to diminish those inequalities, but not so as to relieve the prodigal at the expense of the prudent'.

Furthermore, before concluding that a tax system under proportionality lacks vertical equity, the other tax instruments (such as donations tax and estate duty) should also be considered as possible compensating measures. More to the point is that a holistic approach, with an understanding that all taxes must be paid from income, is required before concluding that progressivity is the only means to achieve vertical equity.

Progressivity also has the effect of pandering towards satisfying perceived equity (in that the rich pay proportionately more) over actual equity in an effort to 'inspire confidence on the part of the relatively less well-off' (Margo Report, 198:52). As Friedman (1980:143) said, there is 'public tolerance of a moderate amount of redistributive taxation'. Therefore, with such disparities, the social benefits of the desired income distribution take priority over concerns of tax equity in determining the exact degree of progessivity, after all 'both progress and justice are costly luxuries – costly, above all, in terms of each other' (Simons cited in Slemrod, 1994:3).

The past few chapters have presented the benefit and ability-to-pay theories; this chapter serves to dismiss the former on grounds of inequity in favour of the equal sacrifice variant of ability-to-pay. An equitable tax rate structure is one where the poor are exempted from taxation with proportional tax being levied thereafter. Overall, these theories and the equity standard adopted in this chapter can only apply to natural persons. This is further supported in the next chapter which seeks, unsuccessfully, to apply these theories to corporations.

Chapter 6 – Application of the Benefit and Ability-to-Pay Principles to Corporations

Introduction

With an equitable standard for tax thus derived, the question is then posed as to how this can be attained with respect to the corporate income tax. It is now evident that neither the benefit principle nor the ability-to-pay approach makes any explicit reference to corporations; they were premised upon natural, and not juristic, persons.

A superficial enquiry would submit that this is predominantly as a result of the fact that the corporate entity did not feature as significantly in the economic landscape during the 18th and 19th centuries (when the equity standard was most emphasised and pioneered) as it did in the 20th century and thus did not necessitate explicit recognition.[11] This is countered in two respects. Firstly, the theories are absolutes, they are, using Mill's earlier phrase, 'to know what perfection is' (Mill, 1848:155). Being an absolute standard means that it is not predicated on legal constructs nor would change when new vehicles of commerce, like the corporation, are legislated or become more widely used. Secondly, even with the dominance of juristic entities in the 20th century and their role in the modern capitalist society, the premise that companies do not play a role in tax equity still holds true. As one of the greatest contributors to the field of modern public finance, Richard Musgrave (1976:291) asserts, 'in the end all taxes must be borne by people and that the concept of equitable taxation can be applied to people only'. This latter point underscores one of the most important insights of the theories, being that equity refers to individuals and not legal constructs. The above becomes even clearer when overt attempts are made to apply the benefit and ability-to-pay theories directly to corporations.

[11] It should be noted that in any event the company is explicitly addressed as 'early' as 1776 in the *Wealth of Nations*.

The Benefit Principle

It has been argued that the benefit principle can be applied to companies as it 'links the corporate tax to some kind of benefit provided by the state' (Avi-Yonah, 2004:10). The types of benefits that are commonly cited are the services that government renders which reduce costs, broaden markets and help facilitate financial transactions. Without even venturing into the details of these benefits or even whether they are due to the state, the first thing to realise is that they do not accrue solely to companies but any business form, including partnerships and sole-proprietors who are not subject to the benefit tax. If this argument were to hold any validity it would call for a general business tax and not a corporate tax.

A more pointed argument is to submit that government undertakes expenditure for companies exclusively. Two things are noted in this regard. Firstly if the expenditure is as specific as proponents suggest then benefit taxation can be attained via *user-charging* and not a general income tax. If specific services are rendered by government and then charged for specifically (such as incorporation fees) one cannot use the benefit argument in favour of both a *user-charge* levy as well as an income tax; it is one or the other. Secondly, even if one were to accept the validity of the argument that a corporate income tax should exist, the quantum would be a small fraction of what it is under the current system and could hardly justify the prevailing tax code with all its provisions and complexities. What the benefit tax implies is a simple annual fee which is hardly akin to the corporate tax under debate.

This then raises the question as to the appropriate tax base as an annual fee is not determined by the company's profits. Musgrave (1976:294) argues that profits do not even rank as a good indicator of benefits received by the entity. Other more realistic bases include property value which would measure the extent of state protection; employment which would reflect the benefit from government school education; transportation costs as reflects road usage etc. The only policy prescription that could be deduced is that the best overall proxy may be company costs and not profits as after all 'the same benefits apply to corporations that lose money' (Avi-Yonah, 2004:10).

It would be unwise however to dismiss the benefit principle only because it implies a small tax quantum or a *user-charge*. It is the principle at stake and thus a more robust dismissal

necessitates challenging that there are no specific benefits conferred at the states expense beyond those discussed in Chapter 3 (i.e. general defence etc for which it was shown the benefit principle to be nonsensical). Of course, there are benefits of incorporation most notably is that of limited liability but the fact that a company enjoys a benefit of limited liability does not mean that it has come at the expense of the state for which a tax needs to fund:

> 'The institution of limited liability is practically costless to society and hence does not justify the imposition of a benefit tax. The purpose of benefit taxes is to allocate the cost of public services rendered, not to charge for costless benefits' (Musgrave, 1976:294).

A more sophisticated variant of this argument submits that the benefit received is not in the form of limited liability *per se* but rather the benefit that the shareholder enjoys of greater liquidity with access to public debt and equity markets which enhances tradability of the shares. Rudnick (cited in Avi-Yonah, 2004:10) substantiates this fact by noting the correlation between access to public markets and corporate tax. This however fails in two respects, firstly it mistakens correlation for causation as one does not cause the other but are, together, caused as a result of greater profitability and company size. It is also unclear whether there is any correlation between profitability and liquidity as 'most publicly traded entities benefit from the same degree of liquidity but vary greatly in profitability' (Avi-Yonah, 2004:11). Even if the suggestion that the tax base be changed so as to only include public companies were accepted, the burden of proof that benefits are conferred by the state is still not satisfied. After all, liquidity is due to the existence of private stock exchanges, private brokers and private contracts and not the state.

Possibly the strongest motivation for corporate benefit taxation (and thus requiring particular attention) is to capture within the tax net foreign entities who have a domestic source of income. The rationale is that the host country has provided the market conditions that have facilitated the income. 'There probably is some correlation between, for example, the quality of infrastructure or education…and the degree of foreign direct investment' (Avi-Yonah, 2004:11). As this shows, the theory is assuming that a source based system of taxation is the equity norm and not residency. As the discussion below indicates, this assumption needs to be substantiated as the case for residency is also very strong.

In satisfying the source-residency dilemma, the classical economists essentially formulated the analysis around the 'legitimate purposes of government' (Vivian, 2006:83). In this sense, taxes 'had usually been associated with the governmental function of protection' (Groves 1974:29). Montesquieu (1748:207) stated that taxes 'are a payment of part of one's property in order to enjoy the remainder in security'. Mill (1848:156) identifies such security as 'judges, soldiers and sailors…policemen'; in more contemporary jargon, this relates to the governments' enforcement of one's ownership over property as well as a person's right to the legal recourse provided by the state. Therefore, a source rule underpinned by equity is one whereby 'only income which is derived under the protection of the state is subject to taxation by that state' (Vivian, 2006:8).

Whilst a 'source based system is more in accordance with the views of the classical economists' (Vivian, 2006:84) a strong rebuttal comes in the form of the judgment handed down in the case of *Kerguelen Sealing & Whaling Co Ltd v CIR*[12], Stratford CJ who delivered the judgment commented, 'a resident, for the privilege and protection of residence, can justly be called upon to contribute towards the cost of good order and government of the country that shelters him'. It is now not only the protection of income but the cost of good order in the place of residence that is relevant.

Mill (1848:146), also believed that the role of government is far more encompassing than only protection; in light of these 'multifarious' functions, the concept of a residence basis of taxation does, in fact, dovetail with precepts of equity. After all, government does not only protect property but, at a minimum, even the personal well-being of the individual utilising the same organs of enforcement (police and courts). Essentially what Stratford is embracing is that to solely apply a source based system of taxation would absolve a resident whose total earnings are contractually derived abroad from any form of contribution, even though the individual enjoys good order in the place of residence.

Furthermore as the Franzsen Commission (cited in the Margo Report, 1986:398) concluded, such foreign income of a resident does enhance such individual's ability to pay and exemption based purely on source is not justified. Finally, as the Margo Report (1986:397)

[12] 1939 AD 487, 10 SATC 363.

identified, it is residency that is the precondition to such taxation and not citizenship as it is the former in which interaction with government occurs.

Therefore, it is not inappropriate that a resident include in gross income worldwide revenue and non-residents that which is from a source under the protection of the state provided that double-taxation is avoided.[13] As Musgrave (1976:719) confirms, this approach 'is in line with the international view of inter-individual equity'. As such the application of the benefit principle to corporations necessarily neglects the above motivation for residency and confines the philosophical grounding solely to a source basis of taxation. It is submitted that this detracts from precepts of equity.

Above all, even if the source basis of taxation were to be held equitable and thus the justification for corporate benefit taxation more affirmed, it is draconian to maintain such a complex corporate tax system just to collect a benefits payment from foreign entities. And if it were then argued that the same benefits (policing, property rights etc) are enjoyed by domestic corporations too, well then it must also apply to non-incorporated entities who are not subject to the tax thus highlighting the inconsistency. Overall, if one were to rather apply an integrated system and tax corporate earnings at the shareholder level, the entire issue is then resolved – whether the corporation is foreign or domestic is irrelevant (Avi-Yonah, 2004:11).

As the above discussion shows, attempts at applying benefit taxation to companies are tenuous at best. When the above is then contextualised in terms of the broader theory discussed in Chapter 3, it becomes weaker still. The above discussion focussed exclusively on the theory *vis-à-vis* corporations which in no way addresses or overcomes the theory's shortcomings and anomalies that were examined in the previous chapter and was the basis for its overall rejection in attaining the equity ideal.

[13] Who has the first right to tax is not relevant for this discussion however it is noted that the use of Double Tax Agreements is an appropriate mechanism to resolve the issue.

The Ability-to-Pay Theory

The attempt to apply the ability-to-pay theory to companies is simpler to dismiss. Ostensibly, it appears as though companies do in fact have an ability to pay, especially if the term elicits a strict definition. However, this definition is not what the ability-to-pay theory engenders. The former alludes to the 'ability of a corporation to pay a certain tax without going bankrupt or without curtailing its operations' (Musgrave, 1976:292). Expressed like this, the superficiality of the denotative interpretation is apparent. Nowhere in the elucidation of the theory and its implications in Chapter 4 was this interpretation ever alluded to. What the theory posits is that tax is a sacrifice levied upon some kind of personal well-being. The concept of sacrifice was further refined via the microeconomic income-utility function where utility is synonymous with satisfaction. When the theory is expressed in these terms, it becomes clear that it can only apply to natural persons as, after all, no inanimate object or legal construct could ever express satisfaction (or dissatisfaction with the payment of tax) and accordingly do not have utility curves which could measure sacrifice. If sacrifice is taken out of the equation, as it is with corporations, the theory is inapplicable thereto. No further sensible attempt could be made in applying the theory as it fails this first hurdle rendering the two (corporations and the ability-to-pay theory) incompatible.

The fact that only certain legal issues pertain exclusively to either individuals or juristic persons is nothing new in jurisprudence. That the two perform different functions is what necessitates the natural-juristic separation in the first place. As an example, certain parts of the Bill of Rights in South Africa's Constitution can only pertain to natural persons. Aside from the fact that it speaks explicitly of human dignity, the rights which it enshrines such as freedom of religion can only relate to individuals. In the same sense, sacrifice, whether it arises from taxation or otherwise, is a uniquely human trait that cannot be transplanted into the inanimate. It is submitted that justifying the corporate income tax on ability-to-pay is equivalent to this and equally inappropriate. As Jensen and Meckling (1976:311 emphasis in the original) unequivocally assert '*The firm is not an individual*…[it is an] error thinking about organisations as if they were persons with motivations and intentions'.

In Chapter 2 of this paper, the distinction between real and perceived equity was drawn. The divergence between the two is largely as a result of tax incidence. Popular opinion perceives

corporate tax as fair and equitable despite the economic reality (as discussed above and further substantiated in the following chapters). The popular opinion is 'wrong since it is based on fundamentally unconvincing beliefs about the incidence of corporate taxes' (Bird, 1996:1). The irony here is that these misguided notions are as a result of the misinterpretation of the ability-to-pay principle itself. The issue is best expressed by Bird (1996:2):

> 'A particularly naïve version of this argument [ability-to-pay] is that since corporations are separate legal persons…they must have ability to pay taxes and should therefore do so…[however] only people, not things, can pay taxes in the sense of having their private real incomes decreased and a major problem with corporate taxes from the equity perspective is that no one can be sure who is actually paying them' (Bird, 1996:2).

As Bird (1992:2) concludes 'popular support for taxing corporations has a weak logical and empirical underpinning. In contrast, the economic opposition to such taxes has strong logical support'. Politicians, intentionally or unintentionally, have benefited tremendously from this misunderstanding; as Colm (1955:96) remarks 'that the corporate tax is almost ideal from the point of view of the politician. There is no other tax which brings in so much money while making so few voters angry'. In this regard Friedman (1975:96) emphasises the inequity of corporate tax as a political tool by stating:

> *'The fact is at one and the same time the chief political appeal of the corporation income tax, and its chief political defect* [is that] the politician can levy taxes, as it appears, on no one, yet obtain revenue. The result is political irresponsibility. Levying taxes on individuals would make far clearer who pays for government programs' (emphasis in the original).

Conclusion

What this chapter has established is that taxes must, regardless of the corporate legal regime, be borne by natural persons and that attempts to apply the benefit and ability-to-pay concepts directly to companies is irrational. Whilst this lends strong support for the integration of corporate and personal taxation a more robust and theoretically rigorous exposition is still required. Enquiry has to be made as to the true nature of the corporation, beyond its legal construction, to its economic reality. Its role from an economic and social perspective needs

to be clearly established in understanding how equity can be attained and the case for integration confirmed within a modern commercial context. This then, is the theory of the firm and the subject of the next chapter.

Chapter 7 – Contractual Theory

Introduction

The purpose of this chapter is to probe the true nature of the corporate entity and the role it plays in the economic and legal arenas. By doing so, it will become clear that the corporation cannot be the unit upon which tax is levied from both an equity and logical standpoint. Several theories of the corporation will be examined in exposing the corporate entity's true character and in turn how taxation should interact with it. As explained by one legal commentator, 'arguments about how the law [including tax legislation] should treat corporations typically depends on underlying theories about what corporations are' (Millon, 1990:226).

On a general level, the theory of the firm has focussed on the distinction between the corporation as an entity with a real existence separate to that of the shareholder and other participants, and the corporation as an aggregation of individuals without a separate existence. If one accedes to the former, questions arise over the nature and origin of its separate existence. 'Here personification – the attribution of human characteristics – provides the metaphorical mode of isolating components of the entity's essence' (Bratton, 1989:1475). If one however is sympathetic to the second theory then the nature and origin of the corporation are then determined by its aggregate parts.

The Contractual Theory

The leading academic theory of corporations is the contractual, or 'nexus of contracts', theory which posits that corporations do not, in a substantive and economic sense, actually exist but are merely a convenient connection for a series of contracts (primarily between shareholders).[14] The theory submits that 'any useful academic analysis of the corporation must begin by denying its existence and looking through it directly at the various groups of

[14] Whilst the terms contractual and 'nexus of contracts' are used interchangeably, and for the purposes of this paper are synonymous, there is a subtle difference between them. As explained by Gindis (2009:4), a set of contracts refers to the multiple bilateral contracts concluded between parties whereas a nexus of contracts refers to all contracts channelled through a central party and are not concluded one-on-one.

people that interact through it' (Avi-Yonah, 2004:2). This is also known as the aggregate view of the corporation which considers the entity as nothing more than an amalgam of its owners. The concept of a company is 'simply a shorthand description of a way to organize activities under contractual arrangements' (Cheung cited in Gindis, 2009:3).

Whilst this is now the dominant view of the corporation, it was not always held as the prevailing wisdom. In fact, 'economists have only recently begun to understand the economic nature of the corporation' (Butler, 1989:99). Other notions of the corporation such as the real entity theory (see next chapter) were once dominant especially at the time when the modern iteration of the corporate income tax was being adopted in major countries such as the United States (Avi-Yonah, 2004:3). 'The situation changed around 1980 when a new theory of the firm appeared, imported from economics' (Bratton, 1989:1471). The theory to which he refers is the 'new economic theory of the corporation'. Despite its pioneering use of economic analysis grounded in neoclassical economics, 'the theory's aggregate, shareholder-centred, foundation was not' (Millon, 1990:229). Accordingly, the ensuing discussion does not single out this theory in particular but speaks of it in terms of the broader aggregate or contractual theory.

The contractual theory explains why the corporation exists and what role in society it serves. By understanding this, the true nature of the corporation is revealed and in turn why it cannot be a taxable unit. As alluded to above, the theory submits that 'the nature and origins of the corporation are determined by the relationship of its aggregate parts' (Bratton, 1989:1475) which is 'in stark contrast to the legal concept of the corporation as an entity created by the state' (Butler, 1989:100). The contractual theory is founded in private contract. The subsequent discussion focuses on why this is an adequate explanation of the corporation by examining the role a company fulfils in society. This is achieved by first investigating why the firm (which can be either a company or partnership) exists with the next enquiry being the benefits of a company over a partnership.

The utilisation of the firm (meaning the collective) is a way by which transaction costs, in the broadest sense of the word, can be reduced. In Coase's (1937) seminal article on the matter, he submitted that in a world without any transaction costs, there would be no need for the firm because all transactions could be 'handled through spontaneous market mechanisms' (Butler, 1989:103). However once transactions costs are added to the equation, collective

organisation may represent the least-cost method to undertake activities. Coase (1937:392) explains the matter by saying 'that the operation of the market costs something and by forming an organisation…certain costs are saved'. This is not to say that organisation is costless. On the contrary, because there are costs that come with expansion, especially through the loss of information exchange and coordination, it explains why firm size is not limitless.

Other explanations follow a similar line of reasoning; for instance it has been posited that the emergence of the firm is as a response of team production. 'Whenever a team can produce a product or service at a lower cost, firms will exist' (Butler, 1989:104). Given the degree of the division of labour in the modern economy, this motivation has added validity.

When the contractual theory was introduced, it displaced the incumbent 'managerialism' view of the corporation (discussed further in the next chapter). Under this hypothesis, management is placed at the centre with authority over those within the organisation as well as over the processes of production and distribution. The view of the firm was thus of a management structure with hierarchical power. Contractual theory successfully challenged this by asserting that firms 'have no power of fiat, no authority…they do not differ in the slightest degree from ordinary market contracting between any two people' (Alchian and Demsetz cited in Bratton, 1989:1478). Management is rather a continuous process of concluding contracts. Since contracts are voluntary, management power is no longer central as both parties are able to contract elsewhere at their discretion.[15]

The relevant point to this discussion being that the firm represents the voluntary coordinated efforts of the individuals involved so as to take advantage of the net benefits thereof which would not be realised if acting on their own. In essence, the firm arises due to the 'contractual response to the needs of the firm's participants' (Butler, 1989:106). The theory postulates that 'transaction cost reduction best explains private contracting patterns, and they explain firm phenomena only as means to that end' (Bratton, 1989:1482).

[15] It should be noted that this view is the most stringent variant of contractual theory, know as the neoclassical variant. A less stringent formulation, known as the institutional variant, concedes some management power. As mentioned by Bratton (1989:1481) 'differences between the neoclassical and institutional pictures should not be emphasised too much'.

This however begs the question, why the corporation? That is, if the only requirement to exploit the abovementioned benefits is a contractual relationship, then a partnership would suffice; why then is the company so prevalent? At a basic level, the issuance of shares provides limited liability.[16] This facilitates individuals who cannot manage the company to nonetheless invest therein and thus provide capital for expansion; similarly it allows other individuals with little financial capital, but considerable managerial talents, to control the organisation and optimise its operations. Essentially, it is bringing two types of individuals to a 'nexus of contracts' for their mutual benefit. Of course there are still many other additional advantages that are unique to a company as a result of the issuance of shares, such as ability to trade them, liquidity for investors and the participation in, and spreading of, risk. These are added benefits of the contract entered into between the parties and may help explain the incentive to do so and, in part, the *raison d'etre* of the corporate entity.

What ensues from the contractual relationship between the two types of parties is the principal-agent phenomenon and the associated agency costs.[17] Agency theory 'provides the theoretical basis for the contractual theory of the corporation' (Butler, 1989:108). The bottom line is that, whilst the separation of ownership and control does result in benefits for the contracting parties, unity of these parties is nonetheless not a necessary condition for the efficient performance of a firm as a result of agency costs. 'This perspective stresses the voluntary, contractual nature of the corporation' (Butler, 1989:108) – voluntary in the sense that it will not *ipso facto* occur; the benefits of incorporation must be weighed against the resulting agency costs.

As mentioned in the previous chapter, the perceived equity of popular opinion is that companies can and should pay tax given their status as a separate legal person. How then is this separate persona, conferred via general incorporation laws such as the Companies Act, reconciled to the contractual position? The two are not mutually exclusive; 'in essence,

[16] Another oft-cited benefit is perpetual succession; however this does not represent any additional benefit over a partnership. With a change in partners, whilst legally the partnership is considered to end and a new one begins, from an operational perspective, the entity is unchanged. The economic reality is perpetual succession facilitated via contract which is no different from that of a company. As perpetual succession is not unique to the corporation, it is not relevant for this part of the discussion.

[17] Agency costs include both the direct costs of managers acting in their own interests and not that of the shareholders as well as the costs incurred by shareholders in monitoring their agents (i.e. the managers).

corporation law specifies the terms of the contract' (Butler, 1989:121). Furthermore, most of the terms in the articles and memorandum of association can be altered via agreement between the parties. What these rules represent in their unmodified form is a default contract.

Of course, the principal act itself cannot be amended and thus opens the question of how substantial the act itself should be. Whilst this constitutes a separate topic altogether and outside the scope of this research, it should nonetheless be noted that 'most areas of corporate law doctrine have been analyzed from the agency theory perspective' (Butler, 1989:121). This is significant in two respects; firstly agency theory itself is predicated on contractual theory and as such the general incorporation laws implicitly recognise the contractual nature of the company in the first place. Secondly, a substantial part of the act would, in any event, be incorporated into private contracts in the absence of a Companies Act in an effort to reduce agency costs. As an example, Jensen and Meckling (1976:306) in their groundbreaking analysis on the theory of the firm make mention that 'accounting reports would be provided *voluntarily*…and independent auditors would be engaged' (emphasis added). The point being that the default contract, as represented by the act would in many respects be consistent with the desires of the contracting parties. Jensen and Meckling (1976:311) continue that the type of legislation drafted 'determines the usefulness, productivity, profitability and viability of various forms of organisation' but the contractual stance 'holds that individuals' freedom of contract implies a right to do business as a corporation without state interference…it is not a suitable subject for regulation because its activities have a private rather than public nature' (Bratton, 1989:1475). The argument in favour of general enabling acts is that it may be 'reasonable to assume that transaction costs are reduced by legislative provisions of entity status' (Gindis, 2009:13). However, even this, is not a certainty and beyond challenge.

This theory of agency costs directly addresses regulation. Jensen and Meckling submit that shareholders, as the bearers of agency costs (due to their residual claimant status) will invest in companies that minimise such costs (for example through strong corporate governance structures and internal controls) which raises the company's value. Accordingly, it is these market forces that incentivise managers to organise and oversee production in a manner optimally beneficial to shareholders. 'Legal rules may supplement these incentives, but market forces by themselves encourage optimal contracting strategies…reduction of agency costs is the only justification for corporate law' (Millon, 1990:230). The point of this is that at

the most fundamental level there is very little that the law can provide to enhance the company when viewed as a contractual relationship. Taken further, if there is not even room for a Companies Act, the concept that the corporation as a distinct person is further undermined. If the corporation is no longer viewed in these terms the argument for corporate taxation, or at the very least the perceived equity of corporate taxation, is greatly vitiated.

To the extent that corporate law must exist, it should seek to duplicate the terms of the contract that the shareholder and managers would have agreed upon in the law's absence. In this vein, if one looks at South Africa's current Companies Act for example, different provisions apply to widely held companies versus non-widely held companies. What this represents, when examined through the lens of contractual theory, is that the Companies Act is catering for the different circumstances of the contracting parties in legislating their default contract. Taken as a whole, such enabling acts are thus providing the contract between the parties in the form a legal persona but this should not detract from the fact that it is still nothing more than an agreement between individuals that would ensue even without a specific statute such as the Companies Act. The point of this insight is that, when distilled to the fundamentals, to tax a company is to tax the contracting parties and the common view that corporate taxes are justified, especially when leaving partnerships untaxed as a singular entity, has no rational basis. The corporate income tax represents the taxation of the parties and not the firm which, after all, is nothing more than 'legal fictions' (Jensen and Meckling, 1976:310).

The blind obedience to the view that a corporation is a separate person and thus rightly taxable which is so pervasive has, historically, not always been held. As Chief Justice Marshall in the US proclaimed as early as 1819 'corporation is an artificial being, invisible, intangible, and existing only in contemplation of law' (cited in Bratton, 1989:1484). Courts looked to the conduct of individuals for the substance of the business just as one would with a partnership. However, it is increasingly common to consider partnerships in the same light as companies when in fact it should be the other way around – 'it is *not* silly to consider the entry of a new stockholder to be the creation of a new firm' (Alchian, cited in Gindis, 2009:5, emphasis in the original). This aggregate view has also seen support from South African legal scholars, Benade *et al* (2004:57) state that 'a company can adequately be described as an association of persons with the common objective of the acquiring of gain'. Use of the term 'persons' does not necessarily limit the definition to individuals, however where the

definition is further applied to juristic persons in the association it would eventually filter down to natural persons only. In any event, the point of the definition does not hinge on 'persons' but rather 'association'. By describing the company along these lines it invokes the aggregate theory; after all, they have not defined the company as a unit independent of its constituent parts which is the entity theory approach (discussed in the next chapter). Benade *et al* (2004:60) continue later to say that the company 'consists at the same time of its component parts…so the company is on the one hand an aggregate of component parts'.

An implication of the contractual theory is that it does away with the categorisation of activities inside and outside of the company. 'It makes little or no sense to try to distinguish those things which are "inside" the firm…from those things "outside" of it. 'There is in a very real sense only a multitude of complex relationships (i.e. contracts)' (Jensen and Meckling, 1976:311). The word company has little substantive content but is 'simply a shorthand description of a way to organise activities under contractual arrangements' (Cheung cited in Gindis, 2009:3). Taken together this implies the denial of the concept of a corporation itself. In these terms, speaking of corporate tax is meaningless. This notion is not as radical as it might appear; from a legal perspective, to pierce the corporate veil embraces that very concept. Benade *et al* (2004:61) recognise the legal fiction of a corporation when they state 'the courts are prepared to "peer through the corporate veil" to give effect to the reality behind the façade of a company'. It is submitted that the reality of taxation, as an economic variable, levied upon individuals should always be given effect – this is only achievable via integration.

Conclusion

The above has presented the leading theory of the firm. In a substantive and economic sense it represents nothing more than a contractual aggregation of its shareholders and as such the tax burden is shouldered by them and not the 'legal fiction' of a company. In these terms, the Companies Act can be viewed as the default contract; whilst it is often perceived as a regulatory tool, the market is far more effective as it incentivises management to minimise agency costs and act in the shareholders best interests. The overall position is best articulated by Butler (1989:122):

> ‘The contractual theory of the corporation has been supported by a tremendous amount of historical, legal and economic research…[it] offers a new perspective on the corporation and the role of corporation law. The corporation is in no sense a ward of the state; it is, rather, the product of contracts among the owners and others. Once this point is fully recognized by legislators and legal commentators, the corporate form may finally be free of unnecessary and intrusive legal chains.

It is submitted that the most unfair and intrusive of such chains is the corporate income tax.

Chapter 8 – Entity Theory

Introduction

The previous chapter detailed the contractual theory of the firm and its implications for corporate taxation. As mentioned in the introduction of that chapter, the theory of the firm comprises another major school of thought – that the corporation has some form of real existence separate to that of its shareholders and participants. In this chapter, the entity theory is elaborated upon and juxtaposed against contractual theory. If it could be justified that the corporation is something more than contractual relationships between the individuals involved and more than a legal fiction, this would provide a powerful weapon in the arsenal of corporate tax proponents.

The Entity Theory

One form of entity theory is known as real entity theory and is explained by the translator (Maitland in Gierke, 1900:xxvi) of Otto van Gierke's pioneering text on the matter as:

> '[The corporation] is no fiction, no symbol…no collective name for individuals but a living organism and a real person, with body and members and a will of its own…it is a group-person and its will is a group-will'.

Whilst this notion was Gierke's rebuttal to his contemporary Friedrich Savigny who was an advocate of aggregate theory, later generations of real entity theorists found such a strong formulation difficult to defend being based on 'European ideas about the spiritual reality of group life' (Bratton, 1989:1490). These second generation entity theorists contended that 'corporate entity is not a rational being [and it] has no will' (Machen, 1911:265). From their perspective the idea of the entity, as expressed by Maitland above, was best seen metaphorically that 'although corporation personality is a fiction, the entity which is personified is no fiction…although corporate personality is a fiction, it is a fiction founded upon fact' (Machen, 1911:266). Machen (1911:258) believed the problem lay in the mistaken merging of two issues that should remain distinct. First is that the corporation is something different to its aggregate parts and second is that the entity is a person. 'One who denies that

a corporation is really a person…is not at all bound by logical consistency to deny the reality of the corporation as an entity distinct from the sum of its members' (Machen, 1911:256). Accordingly, one could simultaneously reject the strict characterisation described by Maitland above whilst still holding to the view that the corporation was real and distinct from its shareholders. In an effort to create a coherent theory, these second generation theorists attempted to articulate specific definitions and existence tests. However this proved difficult, so much so that the third generation 'contrary to the first two…concentrated on consequences of the entity view instead…Overall, second and third generation entity theorists held that the firm is more than the aggregate of its parts' (Gindis, 2009:8).

As explained by Bratton (1989:1512) though, this form of entity theory did not survive, 'As the management corporation matured, a more suitable set of concepts achieved general currency. As a result corporate realism fell out of currency rather abruptly'. What replaced it was managerialism (discussed later) against which Bratton continues that 'as pro- and anti-managerialist positions staked out within its framework, corporate realism's basis in European speculation about group imperatives must have come to seem out of touch with practice'. And as Avi-Yonah (2004:12) concludes, 'The view of the corporation as a real entity, separate from both its shareholders and the state, has not had much resonance in the tax arena'.

The underlying idea of entity theory, that the corporation has a separate non-aggregated existence, has been justified in different ways over the years. Another justification was the belief that the corporation owed its existence to the state. This brand of entity theory is known as artificial entity theory. Unlike the real entity theory above which views the corporation 'as neither the sum of its owners [aggregate theory] nor an extension of the state' (Avi-Yonah, 2004:30), artificial entity theory posits that 'the corporate entity was considered artificial in the sense that the corporation owed its existence to the positive laws of the state rather than to the private initiative of individual incorporators' (Millon, 1990:206). This idea was perpetuated by the fact that, in the early days of corporate emergence, both in South Africa and abroad, a separate and specific act was required for each instance of incorporation. This is in contrast to incorporation via a general enabling act such as the Companies Act as is done today (Benade *et al*, 2004:58). Even with the promulgation of general incorporation acts the idea that the corporation, as opposed to partnerships, were artificial creations of the state and that the state conferred special privileges, was reinforced. This idea made it politically

feasible to have the corporation highly regulated and in fact was one of the pillars upon which the initial levying of corporate taxes in the United States rested (Avi-Yonah, 2004:20). One manifestation of the theory, as an extreme, was that 'even unanimous shareholder approval could not validate an *ultra vires* act because the shareholders could not create powers not conferred by the state' (Millon, 1990:209). Thus, it was the artificial entity theory that provided the basis and justification for a body of corporate law which explicitly addressed the relationship between corporate activity and public welfare.

The above represented a very potent formulation of entity theory. Despite the fact that such reliance on the state for commercial activity was inconsistent with free-market ideals, the proliferation of the company at the turn of the 20th century triggered a re-evaluation of its true character. 'Concession theory[18] had fallen out of currency; its imagery no longer made sense' (Bratton, 1989:1497). No longer was the company a rare feature in the commercial landscape limited only to public utilities, banking and insurance enterprises but was now common even for small business undertakings (Millon, 1900:208). Such corporate frequency, especially for smaller businesses represented by only a handful of individuals, cast doubt over state reliance. A clear inconsistency in policy between small business corporations and a partnership is evident: why should identical undertakings be treated differently with the former considered a product of the state and the latter not.

Out of this grew natural entity theory[19] which 'conceived of the corporation as the creation of private initiatives rather than state power' (Millon, 1990:211). Being true to entity theory, the natural entity theory still maintained that the corporation was independent from its aggregate parts and wielded a power in its own right. This time however, the source of the power was from shareholders, management and the natural activities of private individuals and not the state. The theory 'tended to assimilate corporate persons to the status of natural persons' (Millon, 1990:213).

This iteration of entity theory, which dominated until the emergence of the 'new economic theory of the firm', (with its contractual thrust and discussed in the previous chapter) was

[18] Concession theory, which submits that the corporation must derive authority from the state, is used interchangeably with the artificial entity theory.

[19] Natural entity theory is largely synonymous with real entity theory.

based on the development and nature of the company itself at the turn of the century. The salient features of these companies, and thus what underscored natural entity theory, is still observed today. Specifically, the existence of conglomerates became common; in turn this meant dispersed ownership, small individual holdings and complex transactions facilitated through a management hierarchy that was vested with total operational control over these commercial behemoths. This has been referred to as managerialism. The managerialist strain of entity theory placed management at the corporation's strategic centre. It became the embodiment of the corporation itself. 'All participants, pro- or anti-managerialists, saw the firm as a structure…[which] gave rise to power relationships and that management dominated the structure' (Bratton, 1989:1476).

This perception of the firm draws an almost impermeable barrier between managers and shareholders. Shareholders were passive whilst management was all-powerful, so much so that 'management groups were unaccountable to higher authority' (Bratton, 1989:1476). If the corporation were then the tool for an all-powerful management, separate from the shareholders, then it could well transcend the contractual and 'legal fiction' notion. As described by Berle and Means (cited in Bratton, 1989:1493), the company was 'a transcendent corporate being akin to a profit-maximizing individual'. Under the artificial entity theory, regulation and taxation was justified based on the state birthing the company. Under managerialism, regulation and taxation could no longer be justified on these grounds. Rather what was submitted by proponents was that uncontrolled management wielded its power illegitimately. Various analogies were even drawn to the political and public sphere, comparing managers to unelected officials (Bratton, 1989:1497). It was this perceived unconstrained power of management that was the justification for the original corporate income tax in the United States. The then president Willliam Taft referred to mangerialist sentiment as his justification for the corporate tax 'as a basis for restricting such managerial abuses of power' (Avi-Yonah, 2004:21).[20] Opponents to corporate tax however correctly characterised it as 'an indirect tax on shareholders' (Avi-Yonah, 2004:24)

[20] It is worth noting that the only equity consideration to which Taft referred was benefit taxation which as discussed in Chapter 3 and Chapter 6 is highly flawed and based on artificial entity theory which too has no economic validity.

As can be seen the issue comes down to the separation of management and shareholder power if managerialism is to defeat contractual theory. The picture painted by managerialists of an omnipotent, all-powerful management body unaccountable to anyone neglects market forces and thus is clearly misleading. Management is accountable to shareholders; at the most basic level, the shareholders are able to terminate management's employment contracts. At a more fundamental level, management is accountable to the shareholders via the market. Power is vested more in the market than in management. When analysed in terms of contractual theory, management is forced, for its own survival, to keep agency costs to a minimum. As such they are incentivised to implement strong governance structures and internal controls. Managerialism incorrectly equates the separation of ownership and control with a lack of accountability. 'Market forces constrain managers to act *as if* they have the shareholders' interests at heart' (Butler, 1989:122 emphasis in the original). It should also be noted that the market is not some amorphous concept. In a very real sense equity markets and movements in a company's share price are central to gauging the performance of managers and their remuneration. The link between management and shareholders is vital because it is this link which supports the contractual theory. The company, via its management, is not a real corporate being; in the economic and true sense, it is an aggregate of contract between individuals, enforceable directly or via the market. Bratton (1989:1499) sums up the situation well:

> 'With this market-based solution, the neoclassicists [proponents of the aggregate theory] rebutted both the managerialists' statement of the corporate problem and their regulatory stance…the managerialist corporate entity almost disappears, dissolving into disaggregated but interworking transactions among participating actors…The "separation of ownership and control", on which the managerialist picture based power, no long matters'.

The shaky ground upon which the entity theory rests is exposed when it is discussed in a more tangible form, being that of corporate social responsibility (CSR). The issue of CSR and taxation, whilst seemingly different, are however just particular manifestations of a more general issue, being whether a corporation is actually a real non-aggregated entity, which if true would then imply both a social responsibility as well as corporate taxation. If however, this is not true, one cannot speak of a company having a social responsibility any more than

one can speak of it having, say, a right to religion or feeling its burden of sacrifice which comes with the equity ideals of taxation.

The CSR issue also has an indirect effect when it comes to the perceived equity of taxation. As mentioned in Chapter 6, it is common perception to view the corporation as not only having tax capacity and an ability-to-pay but also a moral obligation to pay as they are perceived to be distinct players in the economy (Bird, 1996:2). It is submitted that this perception is, at least partly, due to the misguided virtue of CSR which perpetuates the real entity view of the corporation without enquiry into its economic and philosophical grounding. The perception of the theory of the firm is more commonly battled in the CSR arena (and seldom won by contractualists) than the taxation arena and as such the perceived equity of corporate taxation is ever more entrenched in the minds of the general population. This is by no means a new phenomenon; one of the decisive articles on the matter can be traced to the Nobel Prize laureate Milton Friedman which was published in 1970 in the *New York Times Magazine*. Whilst largely the same article appeared in his more academic text *Capitalism and Freedom*, the fact that it appeared in such a mainstream publication is evidence of his desire to raise the issue with the general populace who would be less familiar with such concepts in the hope of exposing the economic realities over popular perception. It is then no surprise that he too was a strong advocate of integration of corporate and personal taxation, raising this issue in the public sphere soon after in 1971 in *Newsweek*. South Africa has not been immune to this misperception either especially with such blind obedience to the various King Reports on Corporate Governance in which CSR features prominently. So much so that one of the country's leading think-tanks, the *Free Market Foundation*, published an extensive monograph on false notions of CSR in 2002.

Recognising the link between CSR and corporate taxation, if one briefly turns to a motivation of entity theory for the former, significant light is shed on the latter. The motivation in question is that of E. Merrick Dodd, Jr (1932). Once the entity theory was accepted, he was then free to make the distinction between the interests of the corporation and the interests of the shareholders. 'Because management worked for the corporation, its obligations to the shareholders were, at best, secondary' (Millon, 1990:218). This begs the questions, what then are the interests of the inanimate legal construct called the company? If not the shareholders interests, then whose? This exposes not so much the flaws in Dodd's CSR argument but more the deficiencies of entity theory. Of course, the company is not operating *in vacuo*, if

management had a policy to spend significant resources that do not yield a return and are not in the shareholders' interests then the shareholders would, in one scenario, terminate their 'contract' with the company and sell their shares or alternatively remove the management by terminating their employment contract. In contrast to the entity justification, the aggregate theory is far more accurate in that management are compelled to further the shareholders' interests.[21] The point being, just like taxation, interests can only exist at the individual level. As Millon (1990:224) concludes on this issue:

> 'The theoretical foundation of shareholder-centered privatized conception…included a complete disregard for the entity-based idea on which Dodd built his corporate citizenship argument…the shareholder primacy principle has been the fundamental postulate of corporate law'.

Conclusion

Entity theory has been an unsuccessful tool in motivating the case that a company is truly a distinct economic player and thus rightly taxable. The entity justifications above represent 'an unrealistic view of the corporation…[and] is difficult to defend' (Musgrave, 1976:293). With the adoption of the contractual theory and its foundations in analytical economic techniques to represent the true nature of firms together with its wide adoption in academic circles (Avi-Yonah, 2004:2), a strong case is made for integration. If the corporation is just a legal fiction then it cannot carry, what is in a very real sense, the sacrifice of taxation. As Friedman (1975:95) unequivocally asserts, 'The elementary fact is that "business" does not and cannot pay taxes…A corporation is a pure intermediary through which its employees, customers and stockholders cooperate for their mutual benefit'. As long as a corporate tax exists, it represents nothing more than a withholding tax on the company's shareholders. With these being the facts, there are far more equitable methods to tax shareholders directly.

[21] This is not to say that management always act in the shareholders' interests, as Friedman (2002:133) indicates, management often act on causes, especially where CSR is concerned, in which they personally believe. Systematic abuses though would not go unnoticed by shareholders.

Chapter 9 – The Effects of Non-Integration

With the case for integration established in order to realise the equity standard, it is still further reinforced when the distortionary consequences of company taxation are exposed – such is the purpose of this chapter. When the substance of corporate taxation is revealed with the understanding that it must eventually burdened by individuals, South Africa's current system looks very inequitable.

For the purposes of assessing the practical effects of non-integration, it is useful to distinguish between small, closely-held companies and larger widely-held ones. The distinction is not arbitrary with the deciding factor being whether the individual shareholders are easily identifiable. It is this criterion which is attached to the term closely-held, small etc (and not the absolute size of revenue or employees of the company). Whilst recognising that the principles, as formulated in the previous chapters, are absolutes, the distinction is thus only useful from a practical perspective (and not theoretical) as it embraces the different dynamics between large and small enterprises. To demonstrate the lack of equity in a non-integrated system, the simplest case of one shareholder in a closely-held corporation will be used. After this it will be shown how the same shortcoming apply in a similar way to widely-held companies also.

In a broad sense, the current system in South Africa is to tax corporate profits at 28 percent (except for Small Business Corporations as defined in s 12E of the Income Tax Act No. 58 of 1962, hereafter referred to as the Act[22]); when the profits are distributed, Secondary Tax on Companies (STC) at 10 percent is applied thereto with the dividend itself being exempt for the shareholder. This results in an effective corporate tax of 35.2 percent.[23] With this established, a comparison can be made between the current regime and an integrated one.

As discussed in the following chapter, there are several methods to integrate personal and corporate taxation. For illustrative purposes, the method used in this chapter achieves integration by attributing the income of the corporation to the individual shareholder which is then included in that shareholder's personal income tax calculation. Just like with trusts

[22] Unless otherwise stated, any reference to sections relate to that of the Act.

[23] This is calculated as follows: 0.28 + (1 – 0.28)*0.1 = 0.352.

where the income is attributable to the beneficiaries, so the corporate income is attributed to the shareholders. Whilst the company does pay tax at the statutory rate, the company does not incur the tax but rather just withholds it on behalf of the shareholder. This is similar to the way an employer withholds employees' tax for the employee. Accordingly, the amount of taxes paid on the shareholder's behalf by the company at the statutory rate is deductible as a tax credit in the shareholder's personal income tax calculation. To simplify the analysis, the examples below assume the corporation to have a taxable income of R100,000, one shareholder who does not earn any other income other than from the company and that the company distributes all of its after-tax profits. Because the company makes this distribution to which STC is applied, the effective rate of 35.2 percent is applicable and not 28 percent.

Example 1.1 gives the tax consequences under an integrated system. As can be seen the R100,000 is attributable to the shareholder who pays schedule tax on it at 18 percent. From this is deducted the primary rebate as well as the corporation withholding tax of R35,200 which was levied at the company level but is incurred at the individual level. The overall position is that the shareholder will receive a tax refund of R26,956 with the company paying R35,200 on his/her behalf. The overall position is an effective tax rate of 8.244 percent which is exactly what it would have been had the income been subject to schedule tax only, for example if it were a salary earned.

A word on the STC treatment is apposite. The STC has been included as part of the integration of the taxes. This underscores the point made in the previous chapters that the corporation is not a tax entity and that eventually all taxes must be borne by individuals – this applies to STC as well. As the example shows, if STC is included as part of the integration, the STC is redundant as the effective tax rate with integration will always be based on the personal income tax schedules regardless of what is occurring at the company level. Without venturing as to whether STC has an appropriate theoretical and economic foundation (as it is outside the scope of this research) integration would thus totally undermine the *raison d'etre* of STC in the first place which is to act 'as a disincentive to distributing profits and therefore as an incentive to plough these back into the company for growth' (Mazansky, 2008:1). Therefore if it is to have any effect its inclusion with the tax credit would have to be disallowed. It is conceivable that National Treasury and the South African Revenue Service (SARS) would pursue this route. Given the imminent retraction of STC this speculation is

futile. For the purposes of these examples it will nonetheless be included as it emphasises a central point of this paper that only individuals can bear taxation.

Example 1.2 shows the taxes payable under South Africa's current tax code. The company is taxed on its R100,000 earnings as though it is truly a separate person from its shareholder yielding taxes payable of R35,200 with an effective rate of 35.2%.

Example 1.1: An Integrated System
(all amounts in rands)

Taxable income attributable to individual = 100,000
Corporate 'withholding' taxes paid = 100,000*0.352 = 35,200
Schedule tax payable on company earnings attribution = 100,000*0.18 = 18,000
Primary rebate = (9,756)
Tax credit = (35,200)
Tax refund = 18,000 – 9,756 – 35,200 = 26,956
Effective tax rate = (35,200 – 26,956)/100,000 = 8.244%

Example 1.2: Current System
(all amounts in rands)

Company taxable income = 100,000
Corporate tax payable = 100,000*0.352 = 35,200
Tax applicable at the shareholder level = N/A
Effective tax rate = 35,200/100,000 = 35.2%

When the two approaches are juxtaposed like this, the inequity of the current system is glaring. It is unfair on several levels. Firstly, it is regressive taxation of the worst kind. A person such as this hypothetical taxpayer earning R100,000 should be in the lowest income tax bracket with an effective rate of 8.2% but is actually subject to a tax rate of 35.2%. Based on the 2010 personal tax tables, this is the rate at which a salary earner of R1,400,000 pays.[24] One way of defining the extent of the overpayment is to simply take the difference in the two rates being 27% (35.2% – 8.2%). To emphasis the regressive nature of this taxation, if the same exercise is undertaken for a higher income of R600,000, the overpayment, as measured

[24] The exact number is R1,391,583 calculated so as to satisfy x in the equation:

$$[152{,}960 + 0.4(x - 525{,}000) - 9{,}756]/x = 0.352$$

by the difference in effective tax rates under the two systems, is only 6.3%. The excess burden is clearly greater for the lower income individual.

Secondly, the current system discriminates against those people who earn their income from business rather than employment. The integrated system achieves the same result regardless. This accords, not just with fairness, but common sense in that the same income of two individuals should be taxed equally regardless of the source. This system is most insulting to notions of horizontal equity.[25] A strong case could even be argued that if equity is to be affirmed it would actually mean taxing the business owner at a lower rate than the employee. The reason being that, despite equal incomes, the business owner has assumed far greater risk than has his salaried counterpart. Calculated risk taking, as exemplified by the small business, is something that government should seek to foster and support rather than undermine and inhibit with such a perverted tax system. One of the central motivations for establishing the close corporation was to provide smaller undertakings with corporate status in an effort to support this sector. It then begs the question why government would then undermine their own efforts by choosing to tax them as companies and not partnerships where it allows for the benefits of corporate status with integration. In this way, government has forgone the opportunity to provide real support to smaller enterprises in the form of financial assistance and fairer treatment via the tax system.

A rebuttal by the *fiscus* to the above would submit that avenues of relief are available to the shareholder. For instance, the person should rather operate as a sole-proprietor or partnership and avoid the situation altogether. However this misses the point; there are significant benefits to operating as a company, especially the limited liability and perpetual succession. It is also a means of allowing the business owner to formally structure the operations and lay the groundwork for future stakeholders. In any event, this in itself is a common criticism of the corporate tax; Avi-Yonah (2004:4) responds directly by stating that

> 'there is widespread consensus among economists that imposing a tax only on certain business entities and not on others leads to significant welfare losses to society as the tax drives business owners away from their preferred form of organisation…[this is] a persuasive case for repeal'.

[25] Horizontal equity was defined in Chapter 4 as the identical taxation of people in identical financial positions. Thus people with equal ability to pay will pay the same amount.

As such, not only is this rebuttal weak but is a reason in itself to abandon the corporate tax. Furthermore, it has been shown that the tax asymmetry between companies and individuals 'has in practice had a significant impact on the choice of the form in which entrepreneurs carry on their business activities' (Margo Report, 1986:194) and with it, the welfare losses above. One such example of welfare losses, discussed in more detail below, is the double taxation of company earnings which does not occur when the same operations are undertaken in non-corporate form.

A further rebuttal by government to the deleterious and inequitable consequences above would be to claim that they are mitigated via the tax breaks granted to small businesses in terms of s 12E. Whilst relief is granted in theory, the criteria to qualify for a Small Business Corporation as defined are so stringent that 'it will not be easy for a company to qualify' (Mitchell *et al*, 2000). For instance, if the shareholder happened to hold shares in other non-listed companies (this is particularly realistic for the so-called entrepreneur who may float several small companies owing to the diverse nature of the businesses he/she is involved with) or a company is above the qualifying revenue threshold but is in operational difficulty such that the taxable income is low despite a relatively high gross income. As can be seen, the limited nature of s 12E is not sufficient in redressing the problems cited above, this is especially so given that s 12E only became relevant, to all intents and purposes, in 2006 with the increase in the qualifying threshold despite the fact that the above scenario has been in existence for decades.

The misdirected taxation and the attendant inequity of South Africa's current system can be further illustrated with a slight variation of the above example. Whilst Example 1 shows how horizontal equity is violated, Example 2 shows how vertical equity also is neglected.[26] Suppose now, in Example 2.1, a wealthy taxpayer who owns a profitable company earning R1,000,000 which is retained in the company and not distributed as the taxpayer has other sources from which to live. As such the relevant tax rate is 28 percent.

[26] Vertical equity was defined in Chapter 3. It is the notion that different income groups should be taxed differently. That is, a person with a greater ability to pay should pay proportionally more.

The company's taxable income of R1,000,000 'vests' in the shareholder and the company withholds R280,000 on the shareholder's behalf. When the attributed earnings are taxed at the individual level, a rate of 40 percent is applied thereto with a tax credit of the company withholding tax. This gives total taxes paid of R400,000 and an effective marginal rate of 40 percent. Schedule tax and the rebate were excluded from this calculation because of the assumption made that the taxpayer is very wealthy. As such he/she is already in the highest income tax bracket from his/her other earnings and as such any additional income is taxed at the marginal rate of 40 percent. The rebate and sliding scale would already have been utilised on the taxpayer's other income. What is of relevance here is the marginal taxation of the attributed company earnings.

Turning to Example 2.2 for the effects of the current system which yields taxes paid of R280,000 and an effective rate of 28 percent. The overall picture therefore is that a very wealthy taxpayer who should be taxed at 40 percent on his/her marginal income is actually only being taxed at 28 percent. It is conceded that the difference is slightly overstated as the retained income by the company will eventually be reflected in a higher share value and thus capital gains tax when eventually sold. However this would only marginally increase the corporate rate above 28 percent given the lower capital gains tax rate as well as the time value of money. In the short run, the wealthy taxpayer is able to maintain a rate differential of 12 percent (40 – 28); in the long run, this will be slightly lower.

Example 2.1: An Integrated System
(all amounts in rands)

Taxable income attributable to individual = 1,000,000
Corporate 'withholding' taxes paid = 1,000,000*0.28 = 280,000
Marginal taxation payable by individual on attribution = 1,000,000*0.40 = 400,000
Tax credit deduction = (280,000)
Total marginal taxes paid = 400,000 – 280,000 + 280,000 = 400,000
Effective marginal tax rate = 400,000/100,000 = 40%

Example 2.2: Current System

(all amounts in rands)

Company taxable income = 1,000,000

Corporate tax payable = 1,000,000*0.28 = 280,000

Tax applicable at the shareholder level = N/A

Effective tax rate = 28,000/1,000,000 = 28%

When Examples 1 and 2 are taken together, one can clearly see the regressivity of the current system. A business owner who depends on the R100,000 company profits for his/her livelihood is excessively overtaxed especially when compared to both a salaried earner with the same income (i.e. a violation of horizontal equity) as well as wealthy individual with a much higher income. The latter is a violation of vertical equity because the rich individual should be paying proportionally more than the poorer one which is not the case. This then has been the effect our South Africa's current corporate income tax regime for the past few decades.

With the abolition of STC imminent and the transition to dividend taxation, the task now becomes to gauge the equity of this change. Unfortunately, the picture, as far as equity is concerned, is still bleak. Treasury has now substituted a dividends tax at the shareholder level for STC. Because the rates of the dividends tax and STC are the same (10 percent), the quantitative effects, and its problems for equity, as illustrated in Example 1 are the same. The effective rate for the individual is 35.2 percent whereas it should be 8.244 percent.

There is a difference from a conceptual perspective though. Whilst the purpose of STC was to encourage growth via retained income, the dividends tax is nothing more than outright double taxation. Because STC was, from a legal perspective, levied on the company, the accounting treatment under *IAS 12 Income Taxes* necessitated its inclusion as part of corporate taxes. Accordingly, a company could increase its profit after tax by not declaring a dividend. This was the intended incentivisation by Treasury for internally funded growth. With the change to a dividends tax, it will not be included as part of the tax expense of the company (despite the fact that it will withhold the payment) or even appear in its income statement. The point being that the rationale for STC does not hold for dividends tax and as such the latter constitutes nothing more than double taxation of corporate income. 'It naturally follows that

shareholders should not be taxed again when dividends are distributed to them, just like employees receive a credit for taxes withheld…by employers' (Avi-Yonah, 2004:7). The reasons why double taxation is unfair needs little explanation as the perceived and real inequity of it is obvious. The argument that the needs of the *fiscus* justify double taxation is baseless. The exigent needs of government should rather be addressed via taxes which are 'clear and plain to contributor and every other person' (Musgrave, 1989:3) and not via this form of double taxation.

Whilst the examples of the current system demonstrated its regressive nature, the double taxation under the dividends tax proposal combined with the oft-cited conjecture that it is the wealthier classes who hold share investments forms the basis of the claim that such as system might be progressive. As Bird (1996:2) says in this regard 'To the extent that corporate taxes reduce the income of shareholders, and shareholders are on average richer than others, such taxes may indeed be progressive in their incidence'. The Margo Report (1986:192) also recognised this and demonstrated the progressivity for hypothetical taxpayers. However, as discussed at length in Chapter 5 progressivity is not equitable either. Mill, along with Adam Smith and David Ricardo, was averse to progressivity and referred to it as 'unjust and impolitic' (cited in Groves, 1974:33). As derived in that chapter, proportionality (above the exemption of the poor) is what constituted the equity ideal of tax rate structures. Deviations from this, whether it be regressivity or progressivity, is a deviation from equity.

In this regard, Musgrave (1976:295) assesses the different ways that the corporate tax burden is distributed among income groups. Under the several different types of 'burden' definitions combined with the several different hypothetical taxpayers (i.e. in different income groups) all for different tax rates and different distribution rates, not one yielded proportionality. The results were either that corporate taxes were progressive or regressive. This, together with the discussion above, strongly infers that the equitable rate structure of proportionality is unlikely ever to be realised with the existence of a non-integrated corporate tax. It is far too distortionary and premised on too many variables about the personal circumstances of the shareholder that tax policy is severely hindered in achieving a clear and equitable rate structure. Even if tax policy does choose to subscribe to a progressive structure, against notions of equity (maybe to pander toward perceived equity or achieve certain redistributional objectives) it must be remembered that 'any such progressivity is "blind" in the sense that it takes no account of the total position of the shareholder and imposes the

same tax on the impoverished elderly pensioner as on the multimillionaire rentier' (Bird, 1996:2). Therefore, the corporate tax rate, to the extent that it is progressive (which is by no means assured) provides no justification for income redistribution as it could, in all likelihood, be having the opposite effect.

Turning to widely-held companies, equity is also conspicuously absent. By increasing the number of shareholders from one to a hundred or to several thousand does not bring about equity. The entire tax structure has to change in order to achieve this, and the way to do it is via integration. Where widely-held companies are concerned, the individual shareholders are more difficult to identify and are not as synonymous with the company as is the case for closely-held corporations. This however raises the complexity for the method of integration and not the consequences in the lack thereof. As the Margo Report recognised that one is still nevertheless 'indirectly taxed on the underlying profits of the company'. Where there is a large and diverse shareholder base, such explicit vesting, as demonstrated in the examples above might be difficult and other methods more appropriate. These issues are discussed in the following chapter.

Where amendments can be made with the transition to widely-held companies, as far as this analysis is concerned, it relates to the type of shareholder. No longer is the shareholder utilising the company to undertake operations for a primary source of income. Rather the shareholder is better characterised as an investor with the shares representing his/her savings. In this case, the earnings of the company would augment the shareholders primary source, for example a salary. Accordingly, the tax bracket to which the shareholder belongs is determined with reference to this primary source. Accordingly, as far as the 'vested' corporate earnings are concerned, it is the marginal rate, and not schedule tax that is relevant. This is similar to Example 2.1. The rate differential, being the difference between the taxpayer's marginal rate and the effective corporate rate (including any dividends tax or STC), can then be computed. As above, one would then be able to see if the effective corporate rate is too high or too low given the taxpayer's ability-to-pay as measured by his/her income level. Without knowing the taxpayer's financial situation, no *a priori* inferences can be made.

A non-integrated system for widely-held companies, just as with the closely-held ones in the examples, discriminates between the sources of the taxpayer's income. A superficial

evaluation would suggest a preference toward shares as the dividends are currently exempt and going forward will be taxed 'only' at 10 percent as opposed to, for example, interest or rental income which are taxed at the individuals marginal rate. This however neglects the 28 percent already paid by the company which in reality is borne by the shareholder in the form of a lower share price. The share price represents the present value of the expected future *after tax* earnings. If the corporate tax were to become integrated the share price would increase by the effective tax rate of the corporation. As long as a corporate tax exists, the share price will be lower by that percentage. When this is understood, the double taxation as burdened by the shareholder with dividend taxation becomes obvious. He/she not only holds a lower valued share as a result of the tax on the company's earnings but is taxed again when the company declares those same earnings as a dividend. Similarly, the retained income, that was also at one point taxed, is taxed for a second time as a capital gain when the share is sold. In the language of the Margo Report, double taxation, in this regard, is defined as the 'taxation of the company's profits, which reduces the amount available for dividends, followed by the taxation of those dividends'. It is interesting that the same report recognises that the means of eliminating this totally unfair double taxation 'is to have integration'.

This concept poses a serious obstacle for tax integration and equity. The reason is that the corporate tax has been factored into the share price. With an announcement that the corporate and personal tax regimes are to be integrated, the share price would rise on this information. Why this is unfair is because at the time of the announcement the then current shareholders would have purchased their shares at the tax discounted price and now would enjoy the full benefit of the price rise being an unjustified windfall gain. Bird's (1996:2) response to this is that it should be considered as a 'cost of change rather than a valid argument for maintaining existing corporate taxes'. Even more to the point is Musgrave (1976:301) when he says:

> 'But carried too far, it means that old inequities, like original sin, can never be removed. Whatever the transition problem, this difficulty disappears as new capital comes to be formed and the system develops into a state of more neutral taxation'.

The fact that the change would bring about such large costs, the one mentioned here as well as others, led one advocate of corporate tax integration to remark that 'It is an additional item on the bill of indictment against the tax that getting rid of it is so difficult' (Vickrey cited in Bird, 1996:17).

The investor shareholder discussed above, of course is just one example of a type of shareholder in a widely-held company. In order to undertake a true assessment of the fairness of corporate taxation, all different types would have to be considered. And this underscores the point that to gauge the equity of company taxation is extremely difficult; whether the tax is regressive, progressive or even proportional depends on several variables and multiple permutations. The level of discussion relating to the fairness of the personal income tax and rate structure in the various governmental reports such as the Katz Commissions and Margo Report is extensive, all of which is undermined if a non-integrated corporate tax is then instituted. It is incumbent to recognise that 'corporate profits are part of the income of the shareholders and…should be taxed as part of their income. There is no reason why they should either bear an extra tax or given preferred treatment' (Musgrave, 1976:293).

This is not to say that integration is a simple task. Whilst easy for closely held corporations, there is added complexity for widely-held companies with a diverse shareholder base. This is the topic of the next chapter dealing with various methods of integration and their implications. Despite any complexity that may be encountered, it is borne for a noble goal, that of equity. The oppressive and unfair taxation shown in the examples above for closely-held corporations which is equally likely, but unknown with certainty, for widely-held companies, no longer features. Each person could then pay according to their ability, in proportion to their income and exempting the poor – just as fairness dictates.

Chapter 10 – Methods of Integration

Introduction

The previous chapters have demonstrated, both theoretically and practically, that the only way the equity ideal can be realised is through the integration of personal and corporate income taxes. As such the final task is to examine the various methods of integration, in what circumstances each method is most appropriate and what its implications are.

As STC is such an aberration in the tax landscape – to date only two other countries being India and Romania have ever used it (Mazansky, 2008:1) – and with its imminent scrapping, STC does not warrant much further attention. Effort is rather spent on South Africa's prospective system, which is common internationally, of corporate taxation supplemented by an additional tax on the dividends. This system, 'where the company is viewed as independent of the shareholders [and] both are taxed' (Margo Report, 1986:188) is termed the classical system. In the South African case, even though dividends are taxed at a lower rate and not subject to the taxpayer's marginal rate, this system is still nonetheless considered a variant of the classical system (Margo Report, 1986:188).

Before examining in detail the methods of integration, it is instructive to clarify where exactly the divergence between the classical and integrated systems lies. With this in mind, a more technical definition of integration is the 'adjustment of the system in such a manner that profits are taxed at the personal rate, neither higher nor lower, whether they are retained by the firm or distributed to the shareholder' (Musgrave, 1976:292). Accordingly, the classical system is deficient in that earnings, and thus what constitutes retained income, is taxed at a different rate than that of personal income taxes and dividends are then subject to yet another rate. Pure integration would therefore seek to tax corporate earnings at the correct personal income tax levels and exclude from taxation its distribution. Essentially, the company 'is a conduit, and the shareholder is dominant' (Margo Report, 1986:194). Partial integration, on the other hand, provides more limited relief in that it mitigates the differential tax on dividends only.

Full Integration

Once again, it is helpful to distinguish between small and widely-held companies when assessing the appropriateness of the various methods of integration (Colm, 1955:103). Starting with the closely-held corporation where the shareholders are easily identifiable and are, to all intents and purposes, synonymous with the corporation. Essentially this corporation is nothing more than the conventional partnership with corporate status and as such Musgrave (1976:298) terms this method of integration the partnership method. A more technical term, as used by the Margo Report (1986:188) is 'full integration of company and individual taxation at the shareholder level'. In any event, the process works by imputing the profits of the corporation to the shareholders. Conceptually it is no different to the taxation of trusts in South Africa where the trust income vests in the beneficiary. The system is then further refined by withholding the taxes at source (i.e. at the company level) similar to the way employees' tax is withheld. The benefits of withholding are that it reduces collection cost in that it is easier to collect on the aggregated level of the firm than for each shareholder by themselves. Secondly, it reduces the possibility of avoidance in that the taxes are paid over before it reaches the shareholder. It is for these reasons as well as the one discussed below that such full integration is accompanied with the recommendation for withholding.

The system, taken as a whole entails the calculation of corporate taxable income in accordance with the existing rules[27] to which is applied the statutory rate of 28 percent. This represents the withholding tax. The taxable income is then attributed to the shareholders based on their proportional ownership. This full amount, grossed up for the withholding tax, is then included in each shareholder's own personal income tax calculation that, along with the his/her other income, is then taxed in accordance with the personal income tax schedules and rebates. From this value a tax credit can be deducted for the amount paid on the shareholder's behalf by the company. If the overall total is negative, the shareholder receives a refund whereas if it is positive he/she then pays the deficit. This is embodied in Example

[27] This paper does not evaluate whether the currently derived taxable income calculation accords with equity. This is a complex issue being a topic for another forum. Suffice it to say that a fully equitable tax system would necessitate such an analysis with the assumption here, for the purpose of exposition, that the current system is sufficiently equitable.

1.1 of the previous chapter.[28] As the full profits have been taxed, any subsequent dividends are exempt so as to avoid double taxation. Also, the base cost of the shares would be increased by the amount of income vested so as to avoid double taxation via Capital Gains Tax (CGT) when the shares are eventually disposed of.

By implementing this type of integration, it will always be the case that the corporate profits are taxed at the rates applicable for the shareholder based on his/her ability-to-pay. Whilst there is seemingly a company tax in terms of the withholding, it must be borne in mind that it represents a tax collection mechanism and not a separate type of tax – as is the case with pay-as-you-earn. Furthermore, there is no bias in favouring either a partnership or company as far as taxation is concerned as well as neutrality of the income source: a salaried earner and business entrepreneur who earn the same amount, pay the same tax.

'This proposal seems eminently fair…however certain difficulties with the method have been pointed out' (Musgrave, 1976:299). The first set of difficulties relates to the process itself, regardless of the number of shareholders. The second set stems from the transition needed to apply this technique to widely-held companies. Starting with the former, the primary shortcoming tendered is that tax should not be payable on amounts that have not been received by the shareholder. It is clear from the above that regardless of whether dividends are paid and thus whether the taxpayer has the cash to settle the obligation, he/she is nevertheless liable as the full amount of the corporate income, whether distributed or not, is taxed. It is this criticism to which Adam Smith (1776:825) refers to in his third maxim of taxation that 'Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it…when he is most likely to have the wherewithal to pay'. This criticism, of 'convenience', however is unconvincing. A substantial part of the tax is satisfied via the withholding mechanism thus mitigating any liquidity constraints. This then answers the question as to how the corporate withholding rate should be determined. The current rate of 28 percent is not necessarily appropriate. Whilst this rate is predicated on the revenue needs of the *fiscus*, the withholding rate would be predicated on the issue of convenience. Conceivably, the solution could be approached by possibly taking the average rate for shareholders in general with the result that, on average, taxpayers will not

[28] The only difference is that the tax rate should be 28 percent and not 35.2 percent as STC is ignored for this discussion.

need to pay any additional amount and thus, on average, is not a violation of Smith's third maxim. Alternatively, one could set the corporate withholding rate at the same level as the highest personal income tax bracket[29] in which case the convenience problem is solved for everyone; recognising that SARS would then be refunding more people compared to the 'average' alternative. In any event, this same criticism could be levelled at the taxation of partnerships as the income accrues to the partner regardless of the payout. As such, the withholding tax method would actually mark an improvement for partners' convenience that, *ceteris paribus*, could induce them to incorporate.

The second type of difficulty challenges the applicability of this method for widely-held companies, specifically that it would be too onerous if applied thereto. In this regard, Musgrave (1976:299) rebuts that 'It is difficult, however, to see the reasons for this argument. Taxable profits, once determined, can be prorated by shares and shareholders can be notified accordingly, just as dividends can be assigned'. This latter point has particular relevance for South Africa's proposed new dividend tax as it requires the company to identify the recipient. As Mazansky (2008:1) says in this regard, 'Companies will find themselves saddled with a significant increase in administration as a result of the switch. The reason is that they will now have to ascertain the tax status of all their shareholders'. The point being that integration does not pose administrative complexities that are not already present and thus the argument has very little force. This is not to say that administrative bottlenecks should be ignored or that integration is simple, rather that the challenges, for the most part, are not insurmountable. Of course, a government may make the judgement that such burdensome administration is so undesirable as to reject this integration technique. As mentioned in the introduction of this paper, other considerations may come into play which might outweigh equity in the eyes of the policymaker; one such consideration may be administrative feasibility. The point of this discussion is not to make this decision for him, rather to show what the equity standard is such that he can determine, in this particular case, whether the benefits of administrative simplicity outweigh the costs of equity. Clearly, in the South African case, administrative simplicity does not rank that high with the new dividends tax which is the worst of all worlds – complex administration for an unfair system.

[29] As shown earlier in this paper, equity dictates only two income tax brackets; one at an effective zero percent to exclude the poor (this can be achieved utilising either a zero bracket or rebates which would bring the effective rate to zero) and a flat tax thereafter. If this proposal were to be accepted, the withholding tax could assume this rate; if it were not accepted then the highest marginal rate could then be used.

It could be argued that Musgrave's comment above is an oversimplification. Whilst this may be true, a broader point is being made, and that is partnership integration can be applied for the vast majority of corporations. It is the rule, not the exception. The applicability criterion is not the absolute size of the entity (say, in terms of revenue or number of employees) rather it's the determinability of the shareholders. South Africa's proposed dividend taxation in any event requires this. On a practical level, accountancy, law and consultancy firms are, if not outright partnerships, are operated as *de facto* ones. It should be noted that the size of such firms can be greater than 160,000 employees with operations in 151 countries.[30] This even applies to other industries such as banks, for example Goldman Sachs, arguably the most profitable of them all, with annual revenues in excess of $45 billion[31], was a partnership up until 1999 and in many respects is still operated as one. The salient point being that if the shareholder/partners can be identified for such mammoth companies, there is only a handful of which this type of integration would not be possible and few, if any, in South Africa.

It is recognised that difficulties lie more in determining who may be the 'partner equivalent' of the company and for how long. The problem is two-fold. Firstly, where shares are traded, the income to be vested would have to be apportioned for the length of time for which the share was held by a particular individual. A time apportionment would have to be applied which, whilst adding to the administration problem, is unlikely to be prohibitive. The resultant apportionment may not be exact, especially where income is not earned evenly throughout the year, however could be estimated with sufficient accuracy such that any difference would be immaterial. In any event, estimates are used elsewhere in the Act and the complexities posed by the calculation itself are no more of an obstacle than these certain other sections. The point being that this, in itself, is insufficient grounds to reject the 'partnership' approach to integration.

Secondly, the use of hybrid debt-equity instruments blurs the line between equity participants and providers of debt financing. The problem however is probably more perceived than real in that whilst these instruments are very complex insofar as valuation and accounting is concerned, it is less problematic for taxation. The simple solution just asks who is entitled to

[30] Taken from the officially published statistics of PricewaterhouseCoopers.

[31] This is taken from Goldman Sachs' most recent annual report (2009).

ordinary dividends and these are the shareholders or 'partner equivalents' of the company. The reason being is that the dividend represents the distribution of the income after satisfying the other claimants. The recipients are the bearers of the residual risks of the entity. The income accrued to the other financing parties should be taxed as interest income in their hands. This would also apply to preference shareholders (even though they are legally classified as equity participants). Their 'dividends' should be taxable as interest with a concomitant deduction allowed in the company's taxable income calculation. This way, the taxable income which 'vests' in the ordinary shareholders is after satisfying the preference shareholders or any other debt claimants.

It should be noted that the use of integration would see far fewer complex hybrid debt-equity instruments which legally appear as debt but in substance are equity. The explosion of these financing tools is in no small way driven by the asymmetry of the tax treatment between interest and dividends. This was described by Franco Modigliani and Merton Miller (1958:294) in their ground-breaking article dealing with corporate income taxes and capital structure. They show that 'with a corporate income tax under which interest is a deductible expense, gains can accrue to stockholders from having debt in the capital structure, even when capital markets are perfect'**.** Therefore, a company which uses more debt in its financing will have greater tax deductions and lower taxes payable thus adding value to the firm – this was termed the interest tax shield. As such complex instruments have been produced so as to provide this benefit of interest deductibility from a legal and tax perspective whilst from an economic perspective the holders represent equity participants. 'The classical system's bias in favour of debt financing leads corporations to categorise financial claims as debt rather than stock and forces courts…to search for the mythical line between true debt and true equity' (Mackie, 1992:2).[32] With integration, there is no corporate tax and no interest tax shield to exploit. The bias disappears and so would the difficulty, to a large degree, in classifying funders as either common equity participants or debt financiers.

Nonetheless, where it may be prohibitive to sanction the 'partnership' technique, another option is available to achieve full integration. This method entails taxation of the movements in the company's share price. Musgrave (1976:299) posits that under this method, taxation of

[32] This is one of the most commonly cited reasons for integration. However, because it is not a fairness issue *per se* and thus not the focus of this paper, no further attention, beyond this discussion, is required.

profits can be scrapped concentrating rather on movements in share value. Its increase represents taxable income whilst a decrease is equivalent to an assessed loss for the shareholder. Whilst implicit in the discussion is that it is best applied to listed shares, nothing precludes non-listed companies for utilising it too, especially if the share price is based on accounting rather than market values. Taking the former valuation technique, the company's equity is determined with reference to its constituent parts, most notably share capital, share premium, retained income and various non-distributable reserves (NDR). The first two of these represents the paid-up cost of the company's shares. Changes in the price however are mainly due to changes in retained income which in turn increases with profits and decreases with losses and distributions. Other movements in the share price would arise with changes in the NDR which mainly represents changes in company value that bypass the income statement, for example land revaluations. Should book value of equity increase, the gain is included in the shareholders personal income tax calculation and a deduction if there is a loss. Dividends which reduce retained income would have to be included in the shareholder's tax calculation. The reason for this is that dividends reduce the share value but do not represent a reduction of income for the taxpayer because they are received by him/her. Under this method both retained income as well as dividends are taxed at the personal income tax rate of the shareholder and as such represents full integration.

Whilst the above was premised on book valuation techniques, the same method could be implemented using market values. This variant can obviously only apply to listed entities so that mark to market changes can be calculated. Where the mark to market is positive, this is taxable for the shareholder; where it is negative, it represents an assessed loss. The exact components of the company's equity do not need to be determined as it is already factored into the share price. In fact, the traded share price is far more comprehensive a measure than historical book values as significantly more information is priced therein. Once again, with attribution of profits reflected in the share price being taxed only at the shareholder level means that full integration is realised. As above, dividends would be taxable for the same reasons. The fact that so many other variables, apart from just changes in retained income and movements in profit, are reflected in the share price might lead one to conclude that market values are an inappropriate base for taxation. However, in many respects it is far better than ordinary accounting income as it utilises the accretion concept. The latter, defined as 'an increase in economic power which can be measured with reasonable objectivity' (Phillips, 1963:14) accord better with taxation and economic concepts as opposed to legal and

accounting ones. The movements in the share price (being the objective measurement) is thus a far better income base than accounting profits. As Musgrave (1976:299) comments, 'The adherent of the accretion principle must respond that if they are not thus reflected [book value measurements], no income has accrued.

There are several benefits to both variants of this integration technique. Firstly, the administration problems relating to the partnership approach is not as cumbersome. No longer is it required for the company to constantly determine who its shareholders are and what their tax status is. Rather each shareholder is to be responsible for submitting the changes in their shares' value for tax assessment, just as they do with their other income. Secondly, and possibly of even greater importance, is that it does away with the need to define a taxable income. Essentially, if the book value method is adopted, then the accounting definition is used whereas if the mark to market method is adopted it is the accretion definition which is relevant. Owing to the complexity of defining taxable income, this is regarded by Musgrave and Avi-Yonah to be of great benefit. However, the case could just as easily be made that this is a significant drawback as it neither necessarily ensures equity nor allows taxable income to be used as a fiscal tool to promote economic growth[33], for example by providing accelerated depreciation for capital purchases.

Despite these benefits, there are many undesirable costs. Firstly, whilst administration costs will decline, collection cost will rise as it is far cheaper collecting a withholding tax from a fewer number of firms than taxing share price movements for each shareholder. Secondly and more fundamentally, without the withholding tax, taxing unrealised gains can be very controversial. The primary reason tendered to rebut the criticism of taxing unrealised gains under the partnership approach was that the withholding tax overcame any such inconvenience. This is no longer the case here. Taxpayers may be forced to liquidate certain assets (which can be costly, especially with distressed sales) in order to satisfy the tax and as such 'imposing tax on unrealized gains is likely to run into significant political opposition' (Avi-Yonah, 2004:9).

[33] This is not to say that fiscal stabilisation is necessarily equitable or should be used, rather that it is no longer an option for the policymaker to pursue. Such issues would have to be considered before concluding whether it is beneficial.

For these reasons, it is submitted that this technique only be used where the partnership approach cannot. Based on the discussion above, the partnership approach should thus be applied to all non-listed companies. For those listed entities for which it would be too difficult, this method could be used utilising the more accurate and market orientated mark to market variant. As it would then only be applicable to listed companies one need not be concerned with 'the usual objections to mark to market taxation based on liquidity and valuation concerns [as] neither of these is an issue for publicly traded shares: They are liquid by definition, and their value can be ascertained on a daily basis' (Avi-Yonah, 2004:9). The fact that they are liquid significantly mitigates the 'inconvenience' problem in the absence of a withholding mechanism albeit does not eliminate it.

Partial Integration

The above represents the ideal as corporate income is fully integrated with the personal income tax regime, regardless of whether those profits are distributed or not. However, full integration has never been enacted. Despite its recommendation at times (most notably by the Carter Commission in Canada) it has often been rejected because of administrative complexity (Hubbard, 1993:122). Another reason may also be that it represents such a significant overhaul of income taxes in general (especially if mark to market taxation were to be adopted) and without the political will to overcome the present state of inertia, legislators will continually subscribe to the adage, that 'old taxes are good taxes' (cited in Bird, 1996:17) in the sense that the system has adjusted to its existence and combined with the lack of any perceived inequity, it thus poses no pressing need for reform.

As such, 'most proposals for integration have focussed on eliminating the double taxation of those earnings which are distributed; in short, dividend relief' (Hubbard, 1993:123). Whilst this a second-best as far as equity is concerned, it still should be discussed as a possible route. Whilst it may be partial, in the sense that it only addresses dividends, it nonetheless is a significant step forward especially that it eliminates double taxation. Also, by recognising the political constraints that accompany any tax reform, and in particular, one that is as pervasive as integration, partial integration may be a convenient half-way house on the destination to fairness. With the passage of partial integration and the benefits it confers, the next step

would then be to aim for full integration. That is, a staggered approach may be the only means politically of achieving the ideal.

Partial integration can be achieved via two methods. The first, known as the imputation credit method, is to retain the corporate income tax as a distinct tax (as opposed to a withholding tax). The company calculates it tax liability in the usual manner. When a dividend is declared out of this after tax income, shareholders would then gross-up this dividend for the corporate taxes paid and include it in their personal income tax calculation. After schedule tax and rebates have been calculated, the individual is able to then deduct a tax credit 'equal to the amount of corporate tax that would be associated with the gross dividend' (Hubbard, 1993:123). That is, the credit is equal to the amount of taxes paid by the company on the income that is distributed.

The system thus has equalised the taxation of dividends with the other income of the individual and so avoided double taxation. The retained income and profits of the corporation, however, are not equalised but taxed at the standard company rate. 'Shareholders whose marginal rate exceeds the corporate rate benefit, while those whose marginal rate is less, lose (Musgrave, 1976:300). In the case, however, where all profits are distributed, there is no asymmetry and the system thus becomes that of full integration. After all, the full profit is a dividend subject to the corporate tax which is then credited to the shareholder. Therefore 'there is effectively only one layer of tax – the tax on the shareholder' (Brealy *et al*, 2006:434). To the extent that the current year profits are not distributed, the system diverges from full integration and thus only partially integrates.

Where there is only partial integration a bias exists in the tax code: to the extent that the corporate profits are distributed, the tax is then imputed to the shareholder and borne by him/her rather than the company. As this method is very similar to South Africa's proposed dividends tax in terms of administration, convenience, etc, one would struggle to find any justification for omitting the tax credit other than as a political expedient to increase revenues despite the inequity.

Even though full integration has not been adopted internationally, this method of partial integration has seen the light of day in several countries such as Canada, Australia, New Zealand, France, Germany and Italy (Margo Report, 1986:189). Moreover, as Brealy *et al*

(2006:434) say, with regard to America's classical system 'In fact, the two tier system [classical system] is relatively rare'.

The second method of partial integration, known as the dividend deduction method, treats dividend and interest payments equally by allowing the dividends declared as a deduction in the taxable income calculation. Essentially, under this method, one is taxing retained income only. To the extent that shifting (discussed below) does not occur and it would not change a company's dividend policy, the two partial integration techniques yield the same results. The explicit equal treatment of dividends and interest helps mitigate the bias toward debt financing mentioned above.[34]

Another proposal that exempts dividends entirely at the shareholder level would eliminate the problem of double taxation. This process, known as the dividend exclusion method, is not however considered a variant of partial integration. The purpose of integration is to tax corporate earnings, or at least just the dividends as under partial integration, at the individual shareholder's tax rate. A blanket exemption on dividends does not achieve this; the dividends, which came from company profits, are taxed at the corporate rate – the personal income tax of the shareholder does not feature and therefore it is not integration.

Tax Shifting

The preceding discussion of integration was based on the assumption that the taxes are not shifted. Like any other cost, management may be able to shift the tax partly onto other stakeholders of the entity. For instance, if the tax rate is increased, it might induce management to increase the price of their goods. To the extent that management can accomplish this without a decline in volume of goods sold (typically observed for monopolies), all that has happened is that the tax is reflected in the revenue line, and incurred by customers[35], and not by the shareholders in the form of lower overall profits. In this case, the corporate tax becomes a sales tax and 'its crediting to the dividend recipient would be

[34] For those companies with low dividend payouts the 'deductions can be based on an imputed cost of equity and the average level of shareholders' equity' (Hubbard, 1993:124) thus ensuring equal treatment for debt and equity even for those companies that do not pay dividends.

[35] Customers are not the only stakeholders to which management may shift the tax. Wage earners are another group, who may see their wages reduced by management so as to absorb the additional tax cost.

inappropriate, as it would result in deficient taxation…under the individual income tax (Musgrave, 1976:301). If only part of the tax is shifted, then only partial crediting of corporate income taxes to the individual is appropriate.

It should be noted that the existence of tax shifting undermines, in a practical sense, the entity-theory position that the corporation is the taxable unit as discussed in Chapter 8. Even if entity theory were to be true, to the extent that the tax is shifted, it is not burdened by the corporation. Policy to tax the company is really just a policy to tax customers (i.e. to increase the sales tax). Accordingly, the view that the corporation is a taxable unit is thwarted in the most basic sense 'without a rational place in an equitable tax structure' (Musgrave, 1976:293).

Be that as it may, Avi-Yonah (2004:38) responds to this complication of tax shifting by stating that 'forty years of research on incidence by economists have failed to demonstrate that the tax can in fact be shifted in most cases, at least in the long run'. This is also confirmed anecdotally by the fact that management expend vast amounts of time, effort and money to minimise the tax liability. If it could simply be shifted, one would not observe these practices. Therefore, whilst shifting is something that could conceivably occur (and only then, primarily in the short run), the empirical and anecdotal evidence suggests otherwise and as such the assumption of no shifting underlying the integration techniques is unlikely to be violated.

Other Implications of Integration

With the methods of integration established, the last task is to address some overall implications and consequences of integration, whether it be full or partial.

An oft-cited concern of integration is revenue loss for the *fiscus*. There is little doubt that this would occur; at a bare minimum government would no longer be double taxing company profits. In a broader sense, the layer of corporate taxation is eliminated with only personal income taxes remaining. By recognising the legal fiction of corporations, this entire class of taxpayers is eradicated if full integration were to be pursued. This is not to say that all the taxable profits that companies generate are eradicated too; they are still imputed to the

shareholder and taxed at the individual level. Accordingly, it makes it difficult to quantify exactly how much revenue would be lost. Double taxation aside, theoretically revenues could even increase with integration if it was found that shareholders, in general, pertain to an income tax bracket that is higher than the corporate rate. In any event the tax rates, which would only relate to individual rates with integration, would 'be determined by the revenue requirements of the *fiscus*' (Trotter, 1969:319). The point being that integration does not necessarily mean revenue loss, double taxation aside.

Whatever the merits of this argument are, it must be recognised that it is a separate issue to that of integration. The latter is the mechanism by which taxes are levied, whilst the former is a question of how much taxes should be collected. If it was found that after integration, tax revenues were insufficient, then the personal income tax rates could be increased. The quantum of taxes has no bearing on the fairness of the collection regime.[36] The motivation for integration discussed in this paper holds regardless.

Before integration could ever be realised in practice, a number of concerns would still need to be allayed. Such issues include, *inter alia*, taxation of international transactions, double tax agreements and treatment of tax exempt institutions. Such an enquiry is well beyond the scope of this paper as it deals with the details and minutiae of integration as opposed its motivation and methods of realisation.[37] Furthermore, as with any legislation, before it can be enacted a detailed analysis would still have to be undertaken encompassing the specific nuances and idiosyncrasies of the South African economy. Overall however, these issues are not insurmountable and have been adequately tackled by those countries mentioned above which have adopted partial integration.

[36] Of course, the amount of taxes extracted from the public, and the tax rate itself, do have equity considerations; however this is not the topic of the current paper. Such an enquiry is rooted in political-philosophy. For instance, socialist philosophy submits that high tax rates bordering on 100 percent are legitimate whilst at the other end of the spectrum, anarchists hold that zero rates are justified as no government should exist in the first place. These issues are outside the scope of this paper.

[37] The reader is referred to the extensive United States Treasury Department Study (1992) for detailed analysis of these issues. Such a discussion here detracts from the equity thrust of this paper as they are issues to be addressed once the decision for integration is accepted rather than an equity motivation for acceptance in the first place.

These difficulties would also have to be measured against the fairness and economic benefits that integration confers. Whilst no studies have been conducted on the South African economy, an extensive quantitative evaluation was done for the US economy. It was shown by the Treasury Department (1993:111) that, 'the benefits from corporate tax integration appear to be significant…[and] improves economic welfare' (Hubbard, 1993:128). Whilst the quantitative values presented in the study are less relevant for South Africa (owing to the vastly different states of the economies) the qualitative point is still pertinent that substantial net gains are to be achieved with integration even whilst holding the total government revenues constant (i.e. welfare gains were attributed entirely to integration and not a reduction of taxes).

Conclusion

As the discussion of this chapter clearly demonstrates, integration is a realisable goal in the practical sense of the word and is not just a neat theoretical construct. Whilst full integration is the ultimate achievement if equity is to be secured, the political constraints are nonetheless recognised and therefore, proponents of fairness, may have to temporarily settle for a version of partial integration. This is not to undermine partial integration; after all, it goes a long way in lending a greater level of fairness to the tax structure. There are very little grounds of objection to partial integration; it is administratively feasible and is already a mature process in advanced countries that South Africa could easily replicate. More fundamentally though, partial integration, may inculcate an awareness amongst taxpayers as to what a more ideal system should look like and help undermine the misguided notion that a company is real entity that can bear the sacrifice of taxation. The overall position is best expressed by Musgrave (1976:313):

> 'Integration would involve a substantial revenue loss which would have to be made up and would present certain administrative difficulties. However, it is difficult to defend the present type of corporate tax [the classical system], as compared with an integrated system, if judged by the rule of equal treatment within the income tax structure'.

This is supported more recently by a former high-ranking member of the US Treasury, R. Glenn Hubbard (1993:131), when he notes that ‘consensus is emerging…that integration is desirable’.

Chapter 11 – Conclusion

The need for equity in taxation, as history attests, is of unequivocal importance which can be traced to socio-political factors as well as South Africa's constitution. Furthermore, it secures taxpayer morale and co-operation which is vital in facilitating governments' accumulation of their desired levels of revenue. For these reasons concepts of equity are ubiquitous in literature dealing with public finance. However given the ever changing economic landscape, it is necessary to continually resurvey notions of equity such that it is applied correctly in a modern context.

Theories in achieving equity have been proposed and debated extensively by tax theorist with the primary principles hinging on either benefit or ability-to-pay. The benefit principle attempts to tax an individual based on the benefits received from government expenditure whilst the ability-to-pay principle takes a different approach by considering tax as a sacrifice. The latter has been formulated under two distinct approaches being the equal sacrifice and the minimum sacrifice theory. The equal sacrifice theory asserts that tax is most equitably charged if all individuals sacrifice equal amounts. The minimum sacrifice theory however considers the levying of taxes, not on the individual basis, but on the collective level; thus equity is realised if society as a whole sacrifices the least amount.

These theories, despite being illuminating theoretical constructs, are far from flawless, offering both a constructive and an impractical side. Benefit taxation, whilst attempting to emulate the free market presents many anomalies and aberrations. It is largely confined to *user charging*. Equal sacrifice, being theoretically sound, could not infer an exact scale of taxation whilst minimum sacrifice substituted the problems of quantification with extreme progressivity which is contrary to economic growth. As this research shows, achieving equity in taxation is not an exact science, however very few decisions that government is required to make is precise and taxation is no different.

In this vein, Mill rejects the benefit principle conceptually as well as on grounds of practicality. A direct tax on income, which identifies that all taxes must be paid from this source as well as for reasons of incidence and visibility, is thus considered the most equitable. Progressivity however has no theoretical foundation and ergo the minimum sacrifice theory

with its extreme formulation thereof. Equal sacrifice, with proportionality above the exemption of those unable to pay, is thus the standard in levying taxes fairly.

The concept of equal sacrifice, as posited by Mill, is an exclusively human trait which cannot be applied to corporations and any attempt to do so is illogical and undermines the true intention of the theory. The same holds for benefit taxation. Aside from the fact that it has been rejected as a discrete theory, it too cannot be applied in any meaningful sense to corporations and any efforts so directed are tenuous at best. The fact that the equity ideal of levying taxes only applies to individuals provides a compelling case for integration if equity is to be attained.

The case for integration is further cemented when analysed in terms of the theory of the firm. The fact that contractual theory has triumphed, and is widely accepted over entity theory, confirms the case for integration. The former, with its foundation in analytical economic techniques, shows that the corporation is nothing more than a legal fiction. In a substantive and economic sense it represents simply a contractual aggregation of its shareholders and so the tax burden can only be shouldered by them. Following this paradigm, the corporation cannot be a taxable unit; only individuals can be. In contrast, entity theory has been unsuccessful in proving that the company is a real entity distinct from its aggregate parts. This has far-reaching implications especially for corporate taxation. If the corporation is just a legal fiction then it cannot carry, what is in a very real sense, the sacrifice of taxation.

With the theoretical case for integration affirmed, and the glaringly unfair consequences observed of non-integration, together constitute the most compelling reasons for change. A non-integrated system neglects notions of both horizontal and vertical equity. It is distortionary and has an ingrained bias against business entrepreneurs – the very taxpayers whom the system should seek to support and foster. Furthermore, under non-integration, the equitable rate structure of proportionality is unlikely to ever be realised with regressive and double taxation being the norm.

Thus the only equitable mode of taxation is via integration. The ideal is a fully integrated regime. By implementing this type of integration, it will always be the case that corporate profits are taxed at the rates applicable to the shareholders based on their ability-to-pay. Whilst recognising that there are difficulties in applying full integration, it is also noted that it

is nevertheless appropriate and achievable for the vast majority of companies. In those limited cases where it may be too administratively burdensome, partial integration is still an acceptable second-best alternative and which has been legislated in many advanced economies. Overall, there is no compelling justification that these methods should not be utilised. A lack thereof merely takes advantage of the perceived equity of corporate taxation owing to its supposed separate legal persona even though the reality is vastly different. This is political irresponsibility. All the discussions and analyses in the governmental reports and policy papers surrounding equity are futile if not applied to corporate taxation in the form of integration.

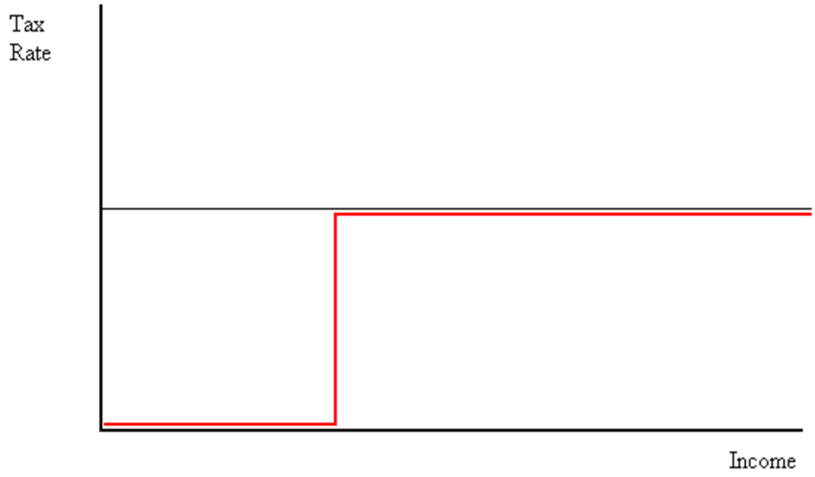
Achieving equity in taxation requires more than mere references to the canon and constitution; it requires an understanding of first principles and the intentions underpinning them. Whilst the political and economic environment is dynamic, the role of equity in taxation is less so. It is incumbent upon the various tax commissions, both domestically and abroad, to ensure that equity is not compromised in the formulation of policy. This often requires an economic and social perspective over an accounting or legal one.

It should be borne in mind that the aim of attaining justice in taxation is sometimes tempered by other requirements. The extent to which these other requirements may trump equity is a decision to be made by the policymaker. The purpose of this paper was rather to identify a corporate income tax regime predicated purely on equity. Deviations from this standard, to the extent the policymaker feels it justified, can now be measured in terms of its cost in fairness. After all, ‘taxation is an art and a technique as well as a science, and it always needs to be judged against the conditions of time and place’ (Groves, 1974:24).

With this said, equity, being in many respects, the single most important consideration in tax policy design is a very achievable goal in the realm of corporate taxation for which the policymaker should strive. Integration of corporate taxes is undoubtedly fairer and more transparent means of taxation. It is being increasingly legislated abroad (albeit the partial variant) and South Africa should not be left behind especially given the country’s new social order that prides itself on being equal and fair.

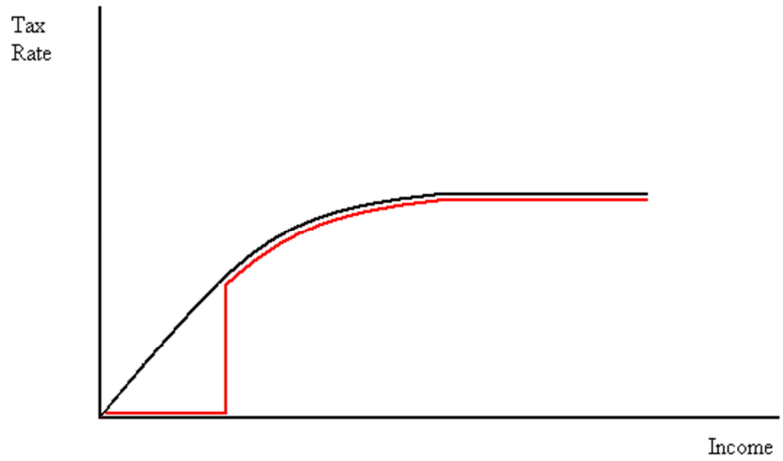
Appendix 1 – Graphical Representation of Tax Rate Structures

Fig 1: A Proportional Rate Structure



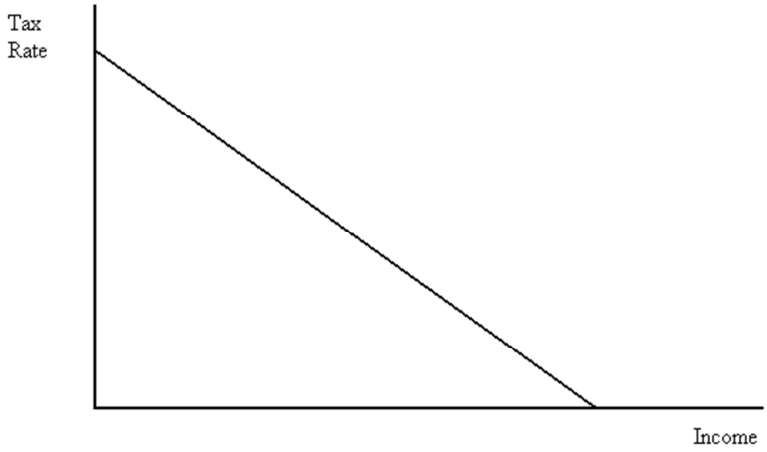
A proportional rate structure, also known as a flat tax is where one tax rate applies over the entire income range; this is shown by the black line. The red graph is a common amendment to the flat tax system in that very low income individuals are excluded from the tax net. As such, below a predetermined level of income (the so-called 'breadline') a zero rate is applied. Above this income threshold, taxes are payable at the flat rate. Zero rate taxation can be achieved in two ways. Either an income tax bracket can be legislated where individuals who fall therein are taxed at a zero rate. The other method, which is used in South Africa, is not to have a specific zero rate income tax bracket but rather allow for an after tax rebate. Accordingly, people whose after tax income is below the rebate pay no tax and therefore are taxed at an effective rate of 0 percent. Strictly, a two rate structure such as this would constitute a progressive regime. However given such rudimentary progressivity, it is best characterised as a proportional rate structure.

Fig 2: A Progressive Rate Structure



The black line shows a progressive rate structure where higher incomes are associated with higher tax rates. That is, higher incomes are taxed at a higher rate. This is in contrast to Fig.1 where all incomes (other than below the 'breadline') are taxed at the same rate. The progressivity need not necessarily take the functional form depicted – the only requirement is that higher incomes are associated with higher tax rates. The reason for this depiction is that it better accords with reality in that generally the rate eventually tapers-off after a given income level and does not rise indefinitely. Strictly, the graph should not be continuous as brackets are often used to affect the progressive structure, as is the case in South Africa. The red graph, as in Fig. 1 embraces the notion of not taxing low income individuals. Above this income threshold, taxation will be progressive.

Fig 3: A Regressive Rate Structure



This graph illustrates a regressive tax rate structure in that as income increases, lower effective tax rates are applicable. Owing to equity considerations this is not done intentionally via the personal income tax system but is rather observed in indirect taxes such as Value-Added Tax (VAT) where the tax paid as a percentage of income is higher for lower income groups, hence the regressivity.[38] As is shown in this paper, regressivity can also result if corporate income tax is not integrated with the personal income tax regime. The extent of regressivity determines the functional form of the graph – it need not be linear.

[38] It is for this reason that multiple VAT rates are instituted. In South Africa, the zero rating is for goods that are considered necessities and comprise a high proportion of purchases for lower income households. By applying the zero rating, the regressivity is, to a degree, mitigated.

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