Capital Tax Reform in the Netherlands?

Towards a more uniform taxation of capital income

CPB Policy Brief  September 2015

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EC seminar November 23, 2015
Summary

- Current taxation of capital income in the NL is a mixed bag:
  it is complex, fragmented and unequal

- This leads to tax arbitrage and distortions of decisions
  of households and firms concerning wealth and capital

- With a number of steps the divergent treatment
  of different forms of capital income can be made more uniform

- This would curb tax arbitrage, contribute to economic welfare,
  and reduce the sensitivity of households and firms
  to the swings of the business cycle

- Six steps are identified – some of them are modest reforms
  - others involve a more major overhaul of the tax system
Different forms of capital income:

- returns to savings – interest
- pension income
- rents, royalties
- owner-occupied housing*
- returns to equity – dividends
- returns to debt – interest
- profits of closely-held business
- capital gains
- wealth transfers – bequests and inheritances

* other real estate, and objects of art and jewelry – not discussed
Low revenues of capital taxes in NL compared to EU

% gdp

Luxembourg  France  Italy  Belgium  Denmark  EU (28)  Austria  Ireland  Finland  Germany  UK  Sweden  The Netherlands
Idiosyncrasies of the Dutch tax system I

mortgage interest tax reduction makes net capital tax revenue on households negative

% GDP

The Netherlands

EU

-2

small business

corporate income tax

local taxes

other property taxes

households
Idiosyncrasies of the Dutch Tax System II

- System of Boxes since Tax Reform of 2001

- Box 1: labour and pension income
  progressively taxed, top rate = 52%

- Box 2: dividend income of owners (>5%) of corporations
  flat tax of 25% (on top of CIT)

- Box 3: “capital gains tax”
  flat tax of 30% on a fixed, fictitious, return of 4%
  therefore *de facto* a wealth tax of 1.2%

  with low realized returns effective tax rates may exceed 100%

- Higher realized returns to larger capitals make Box 3 a regressive tax (CPB, 2015)
Divergent treatment of different forms of capital income

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<tbody>
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\(^1\) Represents different treatment rates for each form of capital income.
Divergent treatment of different forms of capital income

- savings: box 3 – fictitious return

- owner-occupied housing: mortgage interest tax deductible (HRA),
  imputed rental income is taxed (EWF), net remains a huge subsidy

- pension savings: Exempt-Exempt-Taxed but also subsidy

- no taxation of capital gains (but for DGA’s)

- interest payments deductible (debt is tax favoured over equity)

- retained profits not taxed: lock-in effect

- double taxation of owners of small corporations (DGA’s) CIT and PIT
Tax all capital income – as uniform as possible

• alternative based on Optimal Tax Theory and Mirrlees Review (UK, 2010/11)?

• one view: capital income tax is double taxation = inefficient
  – Atkinson & Stiglitz (1978), Chamley, Judd, ..

• recent: some taxation of capital income is optimal given objective of income redistribution and distortionary effect of labour taxation

• different forms of capital are transferable, e.g. personal savings (of DGA) can be made equity in closely held corporation, etc.

• avoid tax arbitrage: i) tax all capital income
  ii) as uniform as possible
Six steps towards a more uniform taxation of capital income

i. tax savings and capital gains based on actual returns

ii. reduce fiscal subsidy on pension savings

iii. tax owner-occupied housing as a capital component

iv. tax equity and debt more equal

v. tax distributed and retained profits more equal

vi. reduce double taxation of profit income
i. tax savings and capital gains based on actual returns

- eventually tax actual returns – equitable, not pro-cyclical
- a tax on interest, dividend and capital gains, not a wealth tax
- administratively difficult?
  - most countries have a form capital gains tax (see Jacobs, 2015)
  - banks etc. can provide most information
  - some areas remain difficult
- Dutch political context: *(belastingplan)* 5 billion Euro cut in labour taxes
  - but progressive wealth tax? (3 fixed ficticious rates of return)
ii. reduce fiscal subsidy on pension savings

• pension savings tax favoured: EET and AOW-exemption for pensioners

• leads to substantial personal wealth in illiquid savings

• leave EET – treatment in tact but ‘fiscalise’ AOW,
  
i.e. let pensioners also pay AOW – contributions
  
(speed up the pace of the ‘fiscalisation’)

and lower the threshold of the EET - treatment
iii. tax owner-occupied housing as capital component

- house is consumption and investment
- favourable fiscal treatment: mortgage interest deduction

- has led to substantial household debt (mortgage) and high housing prices
- households vulnerable to shocks in the economy

- reform: value of house minus debt to be treated as savings, i.e. box 3

- accompanying reforms of rental market and end of transaction tax
- combined a considerable welfare gain (CPB, **: 8.7 billion euro)

- in most plans some tax deduction for own house
  probably an important detail
iv. tax equity and debt more equal

- most countries have favourable tax treatment of debt over equity: interest payments deductible, firms more debt financed
- also firms more vulnerable to economic shocks
- more stringent thin capitalization rules
- more symmetric treatment of debt and equity:
  - ACE = allowance for corporate equity
  - CBIT = comprehensive business income tax
  - latter option still taxes the normal return to capital
  - consequences in the international arena – mobility of capital
v. tax distributed and retained profits more equal

- distributed profits (and sales of equity) are taxed in box 2 (DGA’s)
- retained profits are not: tax deferral / lock-in effect

- avoiding taxation all together? emigration, business transfers to children?
- waiting for a tax holiday? (2007 and 2014, from 25% to 22%)

- three possible reforms
  - **Van Dijkhuizen**: yearly tax on fictitious return, then upon distribution (or sales) settle with realized return
  - **Final withholding tax**: no tax at personal level, i.e. PIT [several European countries]
  - **Dual Income Tax (DIT)**: reverse tax order [Nordic countries] first tax capital income (flat) then labour income (progressive)
## Possible reforms of taxing *DGA* - income

<table>
<thead>
<tr>
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<th><strong>Current situation</strong></th>
<th><strong>Van Dijkhuizen</strong></th>
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<td><strong>Distributed profit</strong></td>
<td>Box 2 PIT</td>
<td>Box 2 PIT (- withholding)</td>
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<td>Box 1 PIT (- withholding / CIT)</td>
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vi. reduce double taxation of profit income

- profit income is taxed twice: CIT and Box 2 (PIT)
- when routes for tax avoidance all together are closed
- and when distributed and retained profits are taxed more equal
- then double taxation could be reduced
- for instance with a lower rate in Box 2
- needs careful examination ...
Outline of a more uniform taxation of capital income

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## Current divergent treatment of different forms – compare!

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\(^1\) CIT

\(^2\) Box 2

\(^3\) Box 3
CPB Policy Brief 2015/16 on Capital Tax Reform in the NL?

• Concluding:

• With a number of steps the divergent treatment of different forms of capital income can be made more uniform
• This would curb tax arbitrage, contribute to economic welfare, and reduce the sensitivity of households and firms to the swings of the business cycle
• Six steps are identified – some of them are modest reforms – others involve a more major overhaul of the tax system

• The CPB Policy Brief presents an outline, a vista of a possible reform (vergezicht)
  – with tax reform however the devil will be in the detail
  – moreover budgetary consequences would need to be assessed