

Investment Incentives in Closely Held Corporations and Finland's 2005 Tax Reform

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Abstract:

This paper analyses the effects of the recent Finnish income tax reform on the behaviour of a closely held corporation (CHC) and its owners. The main elements of the reform are cuts in corporate and capital income tax rates and the replacement of the current full imputation system by a partial double taxation of distributed profits. Considerable exemptions are applied to relieve the taxation of dividends from CHCs. The analysis indicates that the change in the CHCs cost of capital depends on the marginal tax rate (MTR) of the owner. In the case of a high-MTR entrepreneur, the cost of capital increases or is retained at the present level while at lower MTRs the cost of capital may well decrease. The latter observation is due to the increase in the tax rate gap between earned income and capital income. Thus the reform does not remove the earlier reported non-neutralities of the Finnish tax system. The reform will also affect the owner's choice of the form of compensation. Higher taxation of dividends will improve the position of wage income as a form of compensation. This will cushion the effect of the dividend tax changes on the CHCs cost of capital.

Key words: capital income taxation, dual income tax, tax reform

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