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The impact of minimum taxation by an imputable wealth tax on capital budgeting and business strategy of German companies

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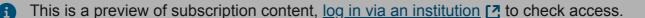
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- 1. In contrast, a large literature suggests that capital income should not be taxed at all. Cf., e.g., the seminal papers of Chambley (1986) and Judd (1985). In contrast, Aiyagari (1995) suggests that capital income taxation may be optimal but should be small.
- 2. Cf. Joint Committee on Taxation (2002), p 7.
- 3. Cf. Ministry of Finance of The Netherlands (2004).
- 4. This minimum wealth tax has been proposed by Germany's Green Party.
- 5. Hansson analyzes the abolishment or suspension of wealth tax in Austria in

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- 8. For distributive reasons.
 - 9. Concentrating on marginal investment decision allows us to identify and isolate taxational distortions. A sophisticated extension of the decision criterion with respect to inframarginal investment projects is provided by Knirsch (2007). We delegate the question of the taxational impact of wealth AMT on inframarginal projects to future research. As inframarginal investments regularly provide sufficient high profits usually they are not burdened by the underlying AMT. Against this background we can abstract from inframarginal projects in the following analysis of a wealth AMT.
 - 10. We neglect uncertainty in our analysis. For an elaborated investigation of the influence of income taxes on investment decisions under uncertainty and a

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- 17. Cf. Appendix <u>5</u>.
- 18. Some more numerical results are provided in Appendix 6.
- 19. The Dutch minimum tax concept leads to comparable interrelations. Cf. Sect.1.
- 20. Thus, we exclude implicit taxes from the analysis.
- 21. A definitive wealth tax burden occurs due to the assumed time pattern of the cash flows. Decreasing cash flows invoke low future tax bases and hence low

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- 27. This decline in value corresponds to the depreciation described in Eq. (1).
- 28. We leave aside the controversial discussion about analyses of representative firms and regard this approach as a first step for investigating this type of AMT, e.g., cf. Shevlin (1990), Stiglitz (1987).
- 29. We analyzed smaller companies as well: small craft and trade partnerships with 5–10 employees, small craft and trade (non-listed) corporations with 5–10 employees and medium-sized companies from metal working industry with 30 employees and a turnover of less than € 2.5 million. In all cases net wealth is lower than € 2,000,000, always generating a wealth tax base of zero. Consequently, in the following analyses we leave aside these types of

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German Federal Bank (<u>1999</u>, <u>2003</u>) and various DAX 30 corporations 1993–2003 annual reports.

- 34. The German local business tax is an additional tax on business profits after some adjustments, i.e. 50% of long-term interest payments are added to the tax base. This tax is deductible from corporate and income tax base. Furthermore, in case of partnerships German local business tax is imputable to the partners' income tax.
- 35. Interdependencies arise from interaction of German local business tax, corporate tax, and supplementary tax. German local tax reduces both, corporate tax base and its own tax base. As the corporate tax is the tax base of the supplementary tax, the later is influenced by German local business

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Schleswig-Holstein (Bewertungsgesetz für Zwecke der Erbschaftsbesteuerung).

- 40. On this basis we deduce the post-tax yield for corporations investing alternatively into riskfree bonds with a 10-year maturity. For e.g., 4.25% federal bond, security code 113533, issued July 4, 2007, maturity July 4, 2017. The pre-tax discount rate is reduced by relevant taxes applying the resulting post-tax discount factor for determining present value.
- 41. Although there are usually specific exceptions for financial services we consider 20% of the liabilities to be representative of an appropriate local business tax adjustment. In contrast, in the case of corporations from the manufacturing industry we assume a fraction of 60% long term liabilities

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may be possible to minimize the tax load by expanding the fraction of distributed profits in this context.

- 47. Conversely, in corporations only income tax on dividend income serves as imputation potential, whereas income tax on managerial salaries does not.
- 48. Note that the underlying data on net wealth only provides information on net equity according to the balance sheet. Information on the market values of the firm is not available. Therefore, the indicated net wealth only approximates real net wealth, i.e. the market value. Further, operating profit in the craft and trade sector includes calculatory employer's salaries.

49. This valuation method is implemented in Germany's Inheritance Tax Code

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Correspondence to <u>Caren Sureth</u>.

Appendix

1.1 Appendix 1: Eq. (2)

To be able to find out under which circumstances the wealth tax discriminates real investment it is necessary to determine $(\hat{t}.) (\hat{t}.) (\hat{t}.) informs about the last period in which depreciation and cash flow time structure lead to an imputation backlog and thus to a (temporarily) definitive wealth tax. If <math>(\hat{t}=0)$ wealth tax is completely and immediately imputable and thereby irrelevant. (\hat{t}) is given by the following two equations:

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holds as future wealth tax base decreases whereas the income tax bases remains constant over time. Keeping in mind that we focus on constant cash flows and before-tax marginal investment projects we get

1.2 Appendix 2: Eq. (4)

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```
 \$ \begin{aligned} \& = \frac{CF_{\{\bar\{t\}\}\}}{(1+i)} + \sum_{t=1}^T \frac{CF_{t} \cdot (1+i)}{(1+i)^{t-\{\bar\{t\}\}+1\}}} = \frac{CF_{\{\bar\{t\}\}\}}{(1+i)} - i\cdot (1+i)^{t-\{\bar\{t\}\}+1\}} = \frac{CF_{t} \cdot (1+i)^{t-\{\bar\{t\}\}+1\}}{(1+i)^{t-\{\bar\{t\}\}+1\}}} \\ & = \frac{CF_{t} \cdot (1+i)^{t-\{\bar\{t\}\}+1\}}{(1+i)^{t-\{\bar\{t\}\}}} \\ & = \frac{CF_{t} \cdot (1+i)^{t-\{\bar\{t\}\}+1\}}{(1+i)^{t-\{\bar\{t\}\}}} \\ & = \frac{CF_{t} \cdot (1+i)^{t-\{\bar\{t\}\}}}{(1+i)^{t-\{\bar\{t\}\}}} \\ & = \frac{CF_{t} \cdot (1+i)^{t-\{\bar\{t\}\}}}{(1+i)^{t-\{\bar\{
```

 $\cdot (1+i)$ { $(1+i)^{t-{bar}\{t\}}+1$ } \$\$

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The income tax effect from the difference between linear and economic depreciation in present value terms is:

```
 \$PV_{\dot \frac{I_0}{T} \cdot \frac{(1+i_{\hat I_0}^T-1)}{i_{\hat I_0}} = \hat \cdot \frac{I_0}{T} \cdot \frac{(1+i_{\hat I_0}^T-1)}{i_{\hat I_0}}  {i_{\tau} \cdot \(1+i_{\hat I_0}^T\) - \(1+i_{\hat I_0}^T\) \cdot \frac{1}{I_0}  (24)
```

1.3 Appendix 3: Eq. (<u>5</u>)

For the overall effect before considering the tax shield from future imputation we observe an impact of income and wealth tax of:

```
$$ \begin{aligned} OA&= PV_{\Updelta D}-PV_{IB}\\ &=\tau \cdot
```

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Obviously, neglecting wealth tax carry-forwards and their future imputation in a first step the positive effect from accelerated depreciation can be overcompensated by wealth taxation (negative overall effect, OA < 0). Then, real investment after-taxes is less attractive than financial investment.

1.4 Appendix 4: Eqs. (6) and (7)

The following Table <u>6</u> provides an overview about the resulting \({\hat{t}}\) for different lengths T of economic life of the underlying investment object and various market rates of return i for $\tau = 0.42$ and $\tau_w = 0.01$:

Table 6 \({\hat{t}}\) for various T, i, $\tau = 0.42$ and $\tau_w = 0.01$

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```
$\$IBA_{{\hat t}} + 5\} = 5 \cdot \int_{w \cdot d_{u}} \cdot \left[ \frac{I_0}{T} - \left[ \frac{I_0}{T} - \left[ \frac{I_0}{T} \right] \right] \right]  $\cdot \frac{T_{\hat t}}{T} - \frac{CF_{\hat t}}{T} \cdot \left[ \frac{I_0}{T} \right] . $ (30)
```

These equations are equal to a arithmetic progression:

```
$\$IBA_{{\hat T}\to \hat I_0}_{T}\right-\tau_w \cdot I_0 \cdot \frac{T-{\hat I_0}_{T}\cdot I_0}_{T} + (t-1) \cdot \frac{I_0}_{T}. $$
```

Discounting to $(t = {\hat{t}}):$

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```
\footnote{T-{\hat{I}_0}_{T}\right-\hat{I}_0 \cdot I_0 \cdot
```

If the economic life of the real investment object ends before the end of the five year carry-forward period a carry-forward is just possible for the remaining \T -{\hat{t}}\) periods. Then, a tax shield of

```
$\$ \left( CF-\frac{I_0}{T}\right)- \left( CF-\frac{
```

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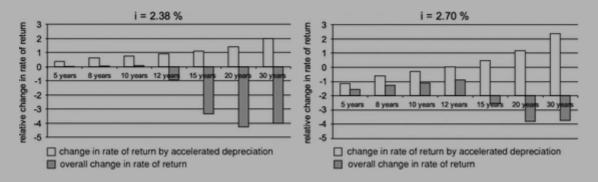
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If we focus on the relative change of the rate of return we get corresponding results:

Fig. 8



Relative change of after-tax rate of return

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Considering a tax allowance of & 2,000,000 no wealth tax is levied on these businesses. In all cases net wealth is lower than & 2,000,000, always generating a tax base of zero. Additionally, taking future profits into account and determining a combined tax base consisting of a weighted average of the present value of future profits and net asset value, 49 the limit of & 2,000,000 is again not exceeded. The legal status of the business does not influence this general result for the craft and trade companies. Consequently, in the following analyses we leave aside these types of business that are unaffected by wealth taxation.

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