Comparative Effects of a Lower Corporate Tax Rate on Small Versus Large Companies

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Key Findings

- Multiple savings and capital income flows with company investment, together with different characteristics and portfolio preference
  - different funds are imperfect substitutes, and smaller elasticity of supply of funds to family-dominant vs multinational company

- Heterogeneity of capital income tax treatment between
  - Debt, dividends, retained earnings, and then
  - Residents (individuals, super), non-residents
    - different effective tax rates

- A lower corporate income tax rate on small versus large companies results
  - Both a smaller reduction in effective capital income tax wedge and a much smaller investment response for small companies
  - Different revenue and income redistribution effects

Australian Taxable Companies, 2013-14

Status and taxable income	Companies		Taxable income	
	Number	% share	$million	% share
Private:				
< $5 million	322,537	98.1	62,059	23.4
> $5 million	2,442	0.7	39,093	14.8
Public:				
< $5 million	2,069	0.6	1,727	0.7
> $5 million	954	0.3	161,550	61.1
Total	328,615		264,702	

Source: ATO, Taxation Statistics, 2013-14

Company funds, investment and income
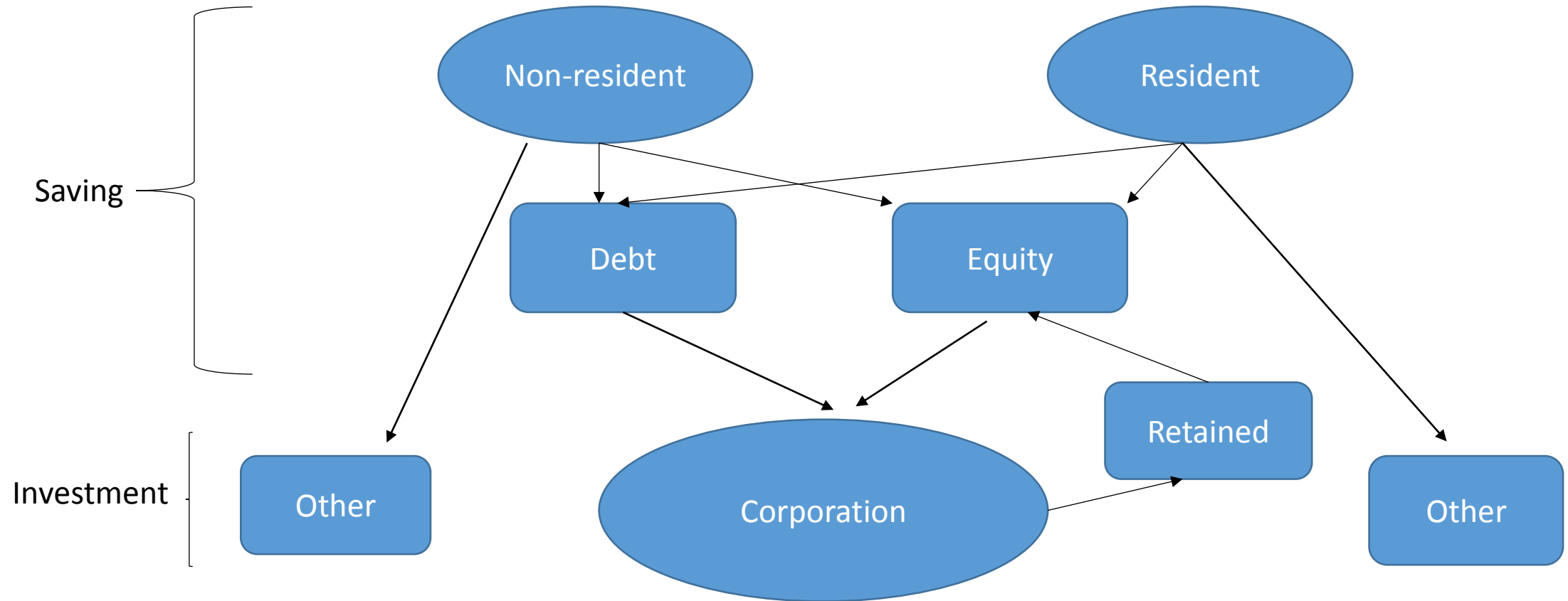
Some Observations

- Mix of type of funds for company investment
    1. debt (about 30%), equity and then most retained earnings. Note they are imperfect substitutes
    2. resident (most for family controlled), non-resident (multinational and large)
- Mix of corporate after-tax income distribution
    - Dividends (about 70%), or retained earnings
- Capital income taxation options with different properties
    - Investor or company: demand side
    - Saver: supply side
- Tax wedge = pre-tax investor return – after-tax saver return

Current corporate income tax base

$Y = R - L - Mat - DebtR - Dep - Otaxes$

$= normal\ return + economic\ rents$

- Residual return to equity, or consumer surplus
- Source base
- Nominal income
- Close to comprehensive base; limited tax expenditures
- Asymmetric treatment of $Y > 0$ and $Y < 0$

Effective tax rates for resident savings invested in companies

- Debt
  - Deduct for company, tax as saver income
  - Tp for household, 15% for super
- Equity and distributed income
  - Imputation system has company tax as a pure withholding tax
  - Tp for household, 15% for super
- Equity and retained income
  - Up to flat 30% corporate, plus capital gains tax on realised increase in share value at 0.5Tp for household and 10% for super
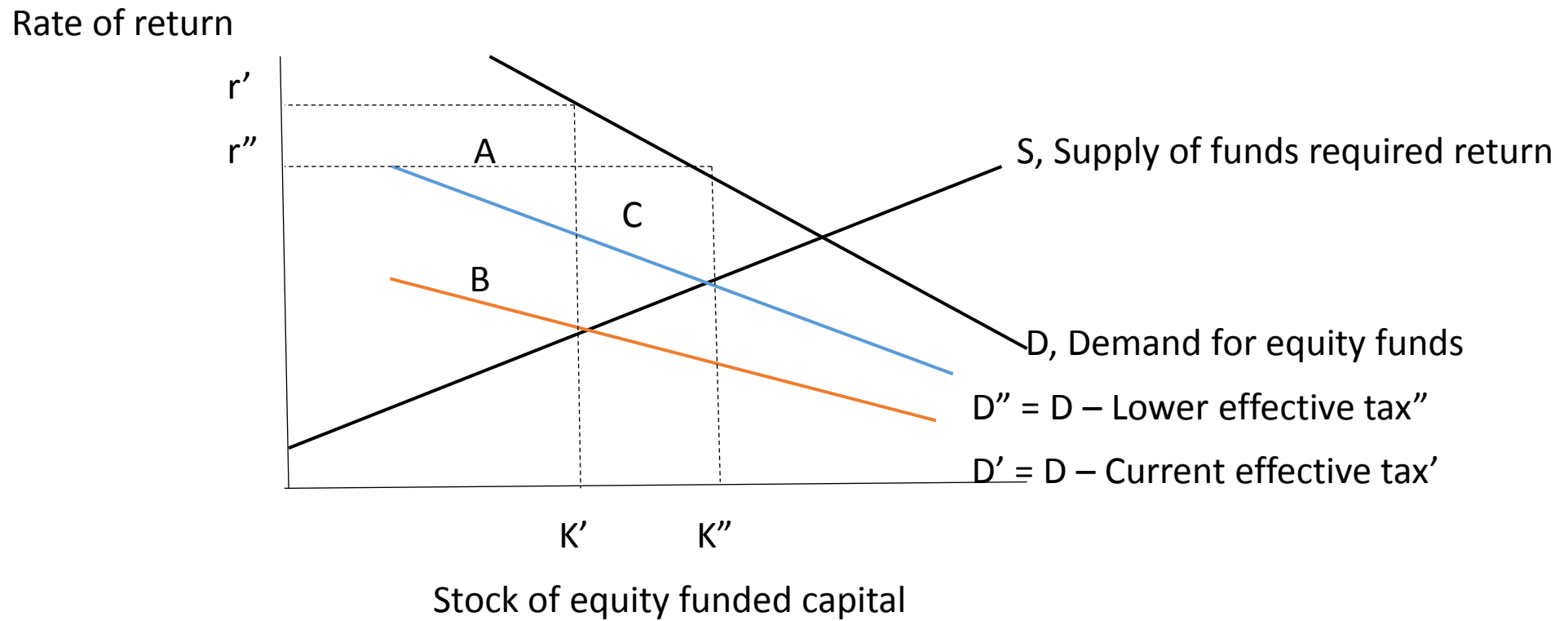
Effective tax rates for non-resident savings invested in Australian companies

- Primary role of bilateral tax treaties setting withholding tax. Very little additional home country tax.
- Debt
  - Deduct for company
  - Low withholding rate for most, with average < 3%
- Equity and distributed income with franking credits
  - Corporate tax rate of 30%
- Equity with distributed income and no franking credits
  - Withholding tax rate generally ≤ 10%
- Equity and retained income
  - Up to corporate tax rate, and generally no capital gains tax

Effects of a lower corporate tax rate on effective tax rates

- Debt, both resident and non-resident: no change
- Equity
  - Resident and dividends: no change
  - Resident and retained earnings: lower rate passed on plus cash flow, with some recapture via larger CGT
  - Non-resident and dividends: $ for $ reduction for franked, and no change for unfranked
  - Non-resident and retained earnings: $ for $ reduction
- **Bottom line:**
  - **Very small reduction for resident shareholders**
  - **Much larger reduction, and close to $ for $, for non-resident shareholders**

Investment and redistribution effects of a lower corporate tax rate

Rate of return

r'

r''

A

C

B

S, Supply of funds required return

D, Demand for equity funds

D'' = D – Lower effective tax''

D' = D – Current effective tax'

K'   K''

Stock of equity funded capital

Comparative effects of a lower tax rate for small companies (resident shareholder and family funds) versus multinational company (non-resident shareholder and global capital market)

- Much larger reduction in effective tax rate for large company combined with more elastic funds supply function for large companies ⟶ much larger investment response (and flow on to higher labour income, GDP, etc)

- ΔGDP ≈ ΔGNI > 0 for small. For large, ΔGDP > ΔGNI, and maybe ΔGNI < 0. Key uncertainty for large is magnitude of effect on profit shifting

- Transfer of lower corporate tax revenue on existing investment to non-resident shareholders larger than revenue gain on additional investment.