Australian National University

Australia's company tax: Options for fiscally sustainable reform

What shall we do with company tax?
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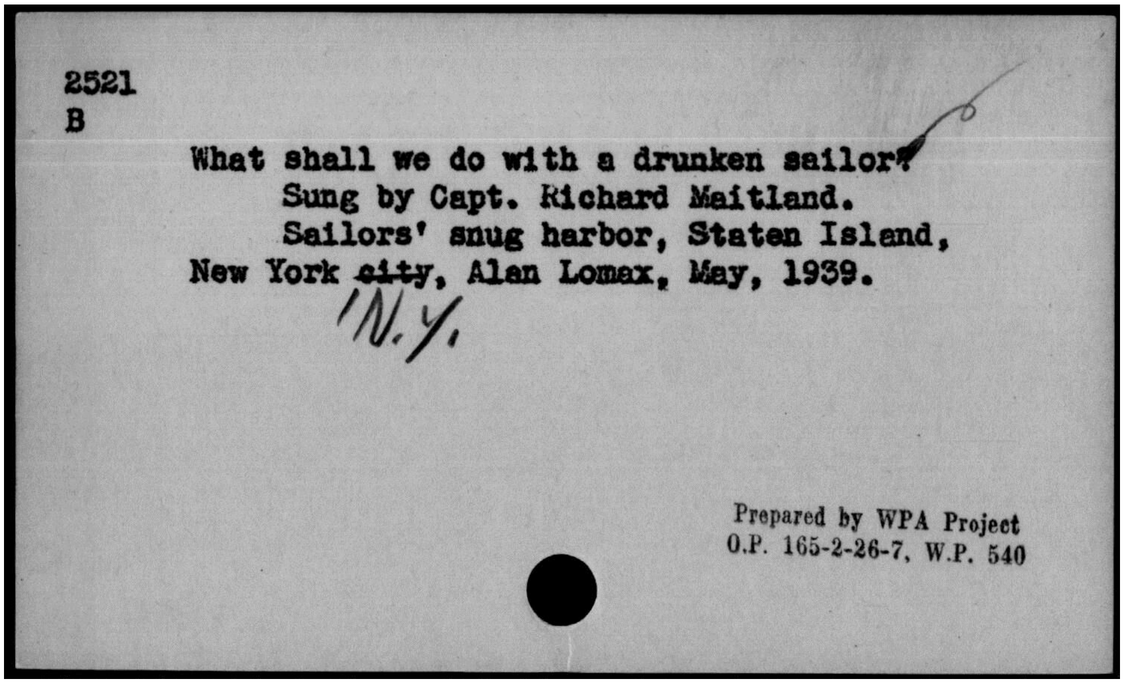
Draft paper



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What shall we do with a drunken sailor?
Sung by Capt. Richard Maitland.
Sailors' snug harbor, Staten Island,
New York ~~city~~, Alan Lomax, May, 1939.
N.Y.

Prepared by WPA Project
O.P. 165-2-26-7, W.P. 540

https://www.youtube.com/watch?v=ZR899VdBEl4

What does company tax do?

- Withholds/back up personal income tax
- Source based: on Foreign investors
- Benefit theory
- “rents” (resources, banks?)
- Delivers subsidies to super funds, domestic savers
- Vehicle for regulation/investment policy for firms

Company tax does a lot, and is important, but:

Companies are not people, or factors of production.

Kind of a “random” or “arbitrary” tax?

Australia’s company income tax

- Rate of 30%, *whither 25% cut?*
  - Reduced rate of 27.5% for SMEs up to $50 m turnover reducing to 25% phased in over coming years
  - ***Is this differential rate structure the worst of all policy outcomes for reforming company tax?***
- Income (profits) base is reasonably broad, ***but***
  - interest deductibility -> thin capitalisation, transfer pricing
  - Creeping accel depreciation; R&D
  - Carryforward losses, deferral of capital gain

Company tax biases

Domestic-Foreign (inbound and outbound)

Debt-Equity

Corporate-Noncorporate Form

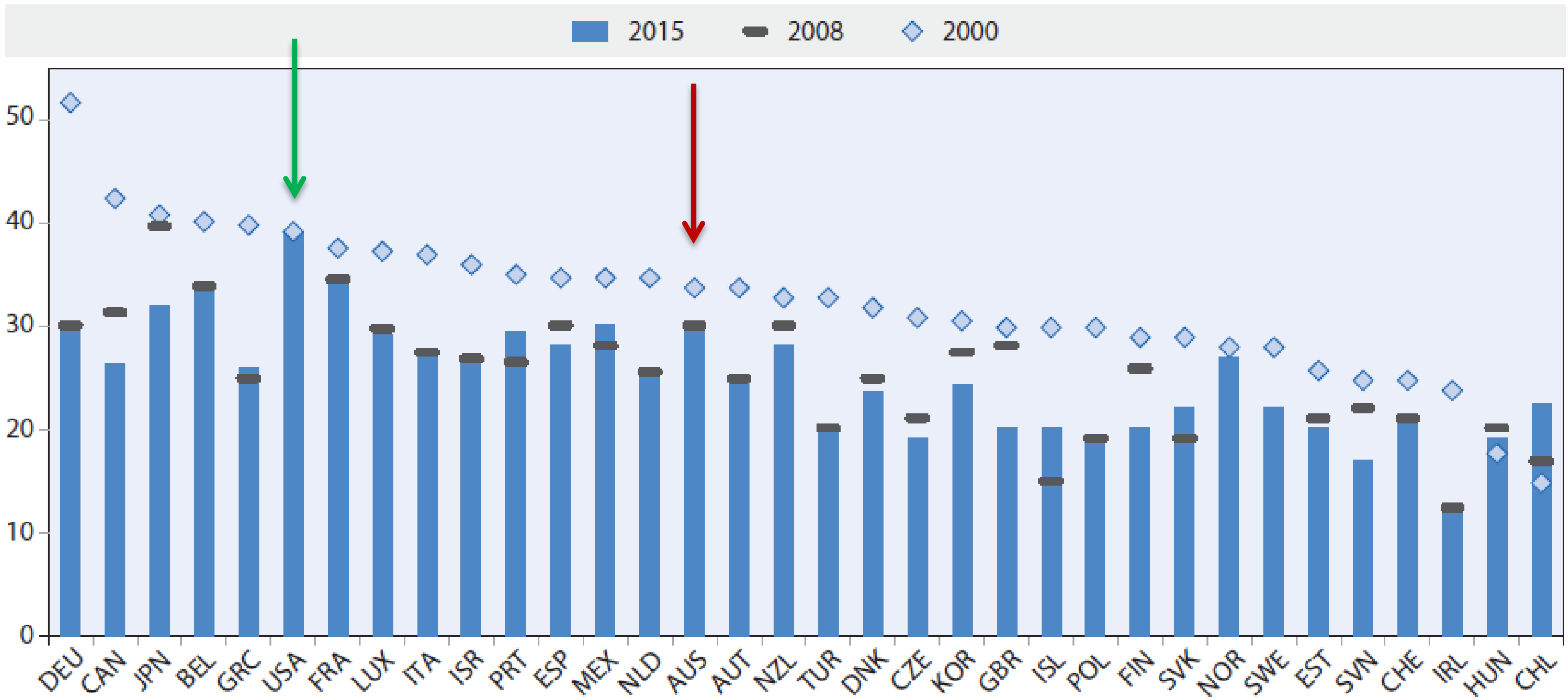
- Dividend imputation Aus SH, taxed profits
- Foreigners face Aus tax of 30% on dividends
  - But 5% or less on interest
  - (*And other deductible or base-eroding payment)*
- Stapled structures, portfolio investment, unit trusts

- Take tax rate competition seriously

- Wait and see what US does

Company tax rates 2000, 2008, 2015 (OECD)

Figure 3.7. **Combined statutory CIT rates, in %, by country**



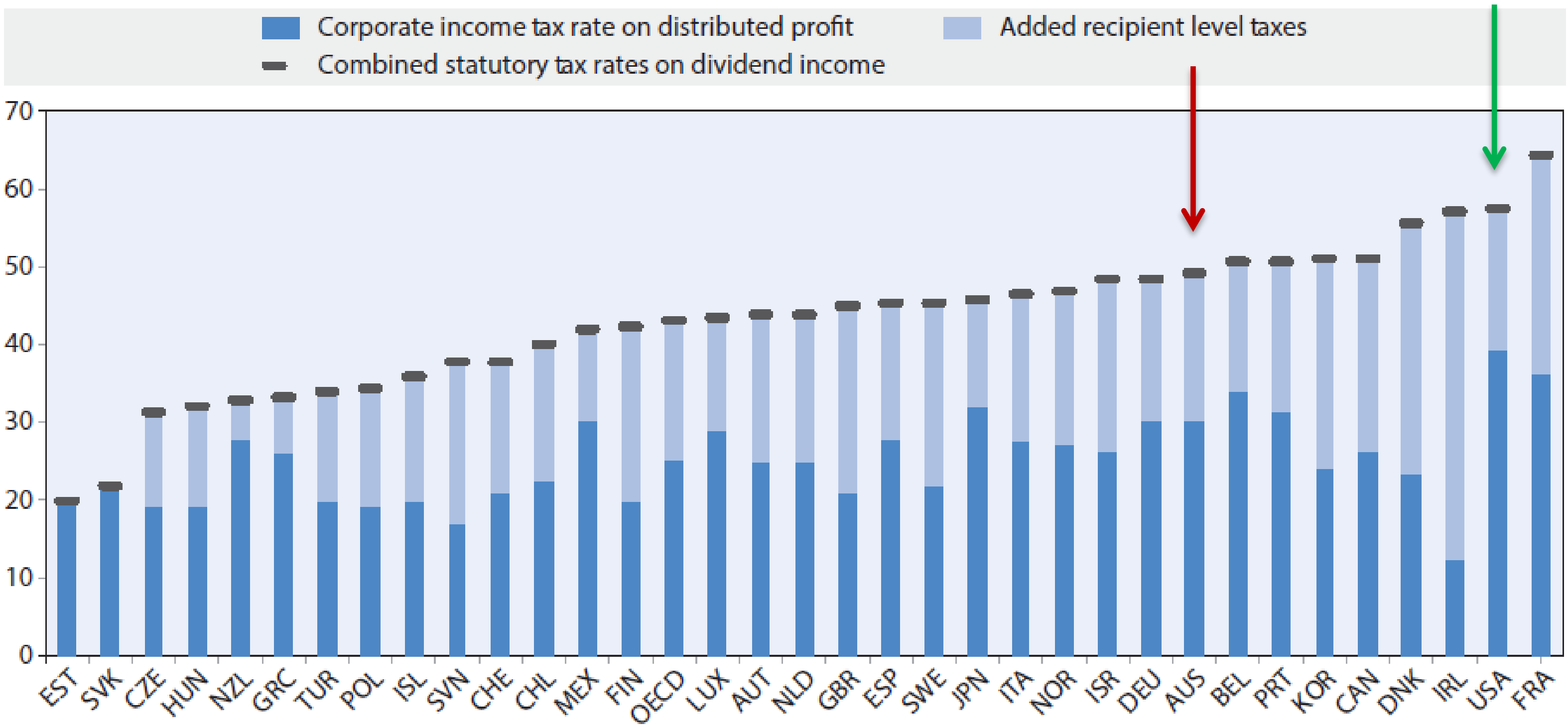
Source: OECD Tax Database, www.oecd.org/tax/tax-policy/tax-database.htm.

Source: Tax Policy Reforms in the OECD 2016 http://www.oecd-ilibrary.org/taxation/tax-policy-reform-in-the-oecd-2016_9789264260399-en

- *But*:
  - Any lower company tax rate makes defending the progressive personal income tax more difficult

Effect for domestic dividends at top rates (OECD)

Figure 3.6. **Combined top statutory tax rates on dividend income, 2015**

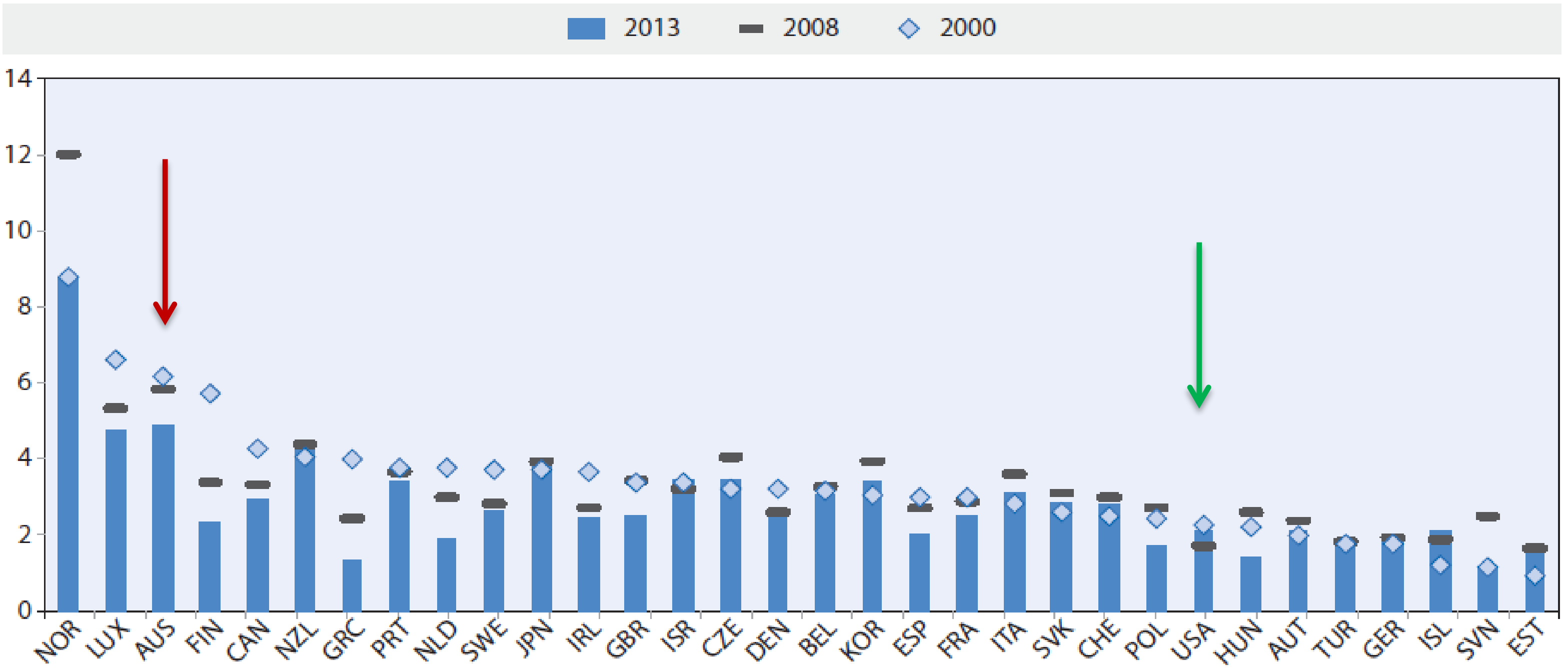


Source: OECD Tax Database, www.oecd.org/tax/tax-policy/tax-database.htm.

Source: Tax Policy Reforms in the OECD 2016 http://www.oecd-ilibrary.org/taxation/tax-policy-reform-in-the-oecd-2016_9789264260399-en

CT revenues function of base, corp profits and SH-corp system, not just rate

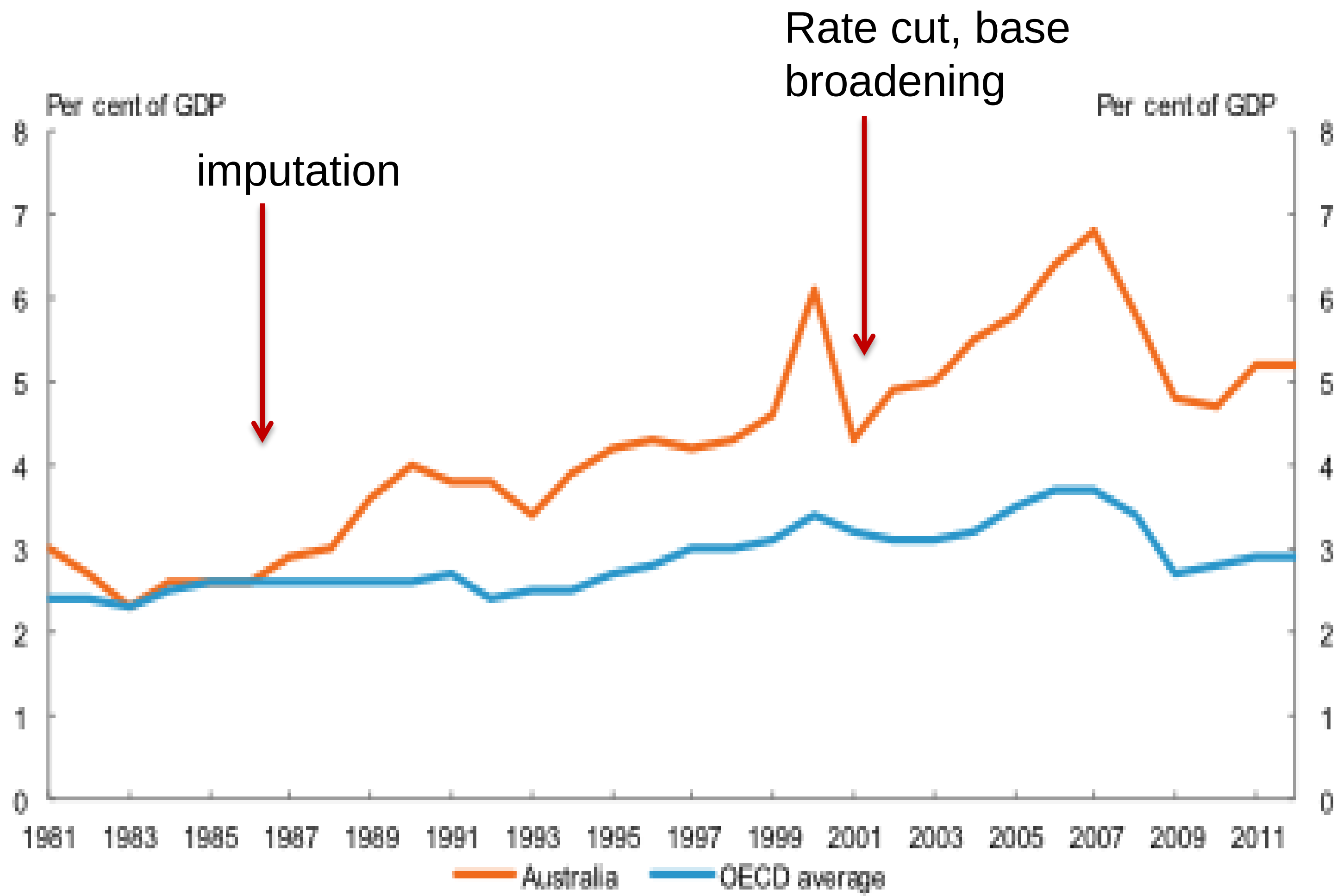
Figure 3.8. **CIT revenues, in % of GDP, by country**



Source: OECD (2015), *Revenue Statistics 2015*, http://dx.doi.org/10.1787/rev_stats-2015-en-fr.

Source: Tax Policy Reforms in the OECD 2016 http://www.oecd-ilibrary.org/taxation/tax-policy-reform-in-the-oecd-2016_9789264260399-en

Company tax revenues in Australia (Re:think Chart 5.3, 2015)



Spectrum: Choosing Company tax base

COMPREHENSIVE INCOME	*Source/Residence*	EXPENDITURE/ CASH FLOW
Broad base		**Narrow base**
Effective life depreciation, accrual tax of gains/profits	INVESTMENT CAPITAL	Accel. depreciation; investment allowances; expensing (R-CFCT)
Interest deductibility, or No interest/equity deduction	FINANCE CAPITAL	Interest deductibility; or ACE; R+F-CFCT

Choosing a corporate tax base

Rent tax: Allowance for Corporate Equity (ACE), removes debt vs equity distortion by making both deductible

- Allowance deductible (not actual payments)
- Interest deductibility remains in the system
- Should have efficiency gains as exempts normal return
- investment costs depreciable under CIT rules
- *Some favour by Henry Tax Review*
- *Some implementation by countries*
- Allowance for Corporate Capital (ACC) includes financial capital (imputed deduction for interest)
- Can be on a sector – super profits tax? Resources, banks

Issues with ACE/ACC/rent tax

- Narrows base so a fiscal cost
  - Requires a higher rate for same revenue
- X-border planning
  - accessing allowance/deduction (Belgium)
- Financial services? (esp. R-CFCT)
- Neutrality depends on choosing “correct” return
  - equity (ACE); equity-debt combined (ACC)
  - Is corporate bond rate right?
  - Unstable: allowance/uplift factor changeable

Choosing a corporate tax base

Comprehensive Business Income Tax (CBIT)

- At corporate level, dividends and net interest not deductible
- Corporate base otherwise: Usual income tax (depreciation etc)
- Broadens base: can finance a tax rate cut
- Eliminates debt:equity bias and thin cap planning

Issues with CBIT

- Increases the cost of capital (taxes normal return)
  - But, lower rate
- X-border: double tax?
  - But, interest not fully taxed across borders anyway
  - Lower rate
- Financial sector
  - How to tax in practice?
- Treatment of non-corporate businesses?
- Transition:
  - What about existing debt? But, lower rate…

- What to do about the shareholder level if we adjust the base in either way?

- *Especially:* What about imputation?

ACE/rent tax – personal level

- This is a shift to a rent tax, ie not taxing normal return to capital
  - Spectrum: moves to the expenditure tax base
  - And we want to retain debt-equity neutrality
- If rents
  - A rate of return allowance at SH level
  - Discount on dividends, interest
  - Imputation -> converts back to income tax base?

CBIT – personal level

- This is an income tax base
- Financing neutrality: we require same treatment of dividends, interest at SH level
- Suggests replacing imputation with:
  - Discount rate for dividends, net interest, CG
  - Could go further to exemption (but want to retain some progressivity)
- Suggests for non-corporate business: same treatment as SH

End 30 years of dividend imputation?

- Clearly makes companies pay Aus tax!
  - Eliminates domestic debt-equity bias
- Debate about pricing of imputation credits
  - Cost of capital: Who is the marginal investor (foreign or domestic; could be different for different kinds of firm?)
- A tax or a subsidy for domestic savers?
  - Supports a “floor” /withholding for personal income tax, ***but***
  - Refundability; exempt pension phase of super; retirees on low rate
  - Rich older individual savers love it; super funds love it (rich older individual savers…) (as *McLaren notes*)
- Complex integrity rules (and debt/equity rules)

Modelling suggests that its removal could fund a lower corp tax rate and this would be more efficient

Summary: Different corporate tax bases (by deductions, x-border effect)

Deductions	**CBIT**	**CIT**	**ACE/ACC**	**Cash flow**	**GST (compare)**
Wages	X	X	X	X	
Investment				X	X
Depreciation	X	X	X		
Debt		X	X		
Equity			X		
X-border: Source/ Destination	Source	Source	Source	Either	Destination

Pragmatic compromise, lower rate?

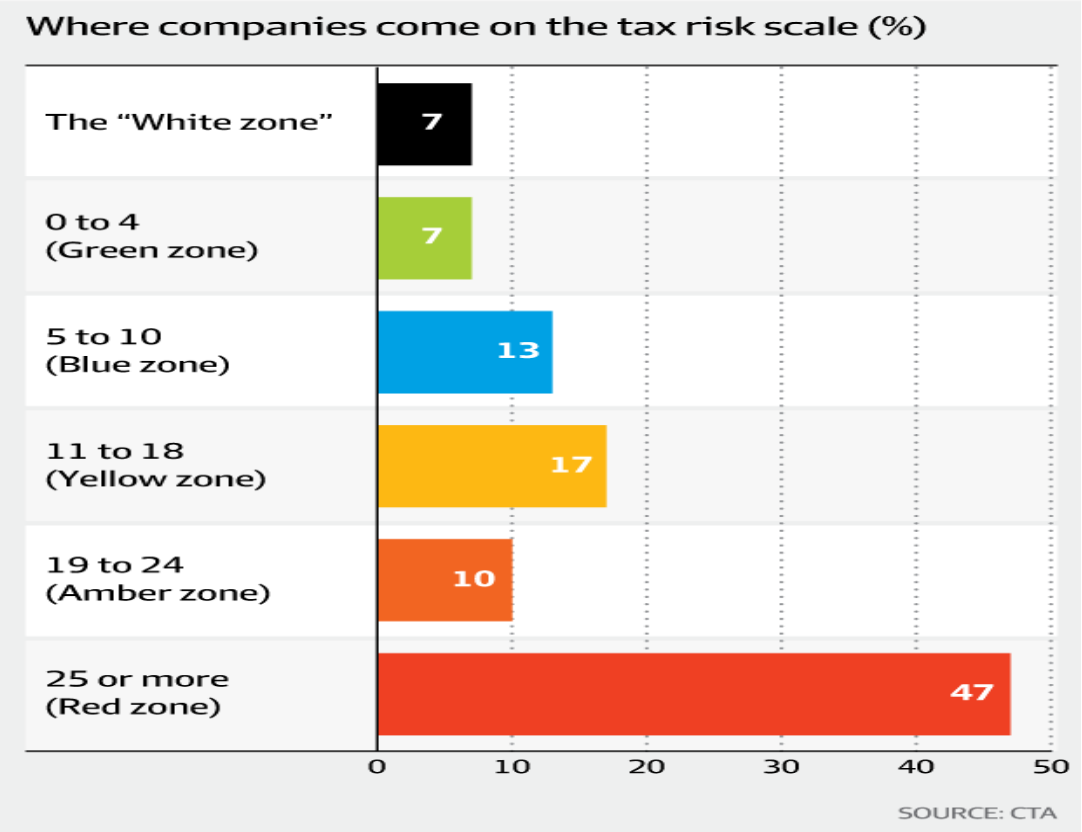
- Lower rate + rent tax on banks - Murphy (2017)
- ACE/remove imputation
- CBIT/ACE tax system Devereux, de Mooij (2013)
  - removes debt vs equity distortion
  - reduce tax of capital investment, increase taxation of rents
- CBIT/Dual Income Tax Cnossen (2016)
  - Dual Income Tax at personal level
  - Gradually increase Withholding taxes on interest and dividends to the (reduced) DIT/Corp tax rate
- ACE/Dual Income Tax (Sorenson & Johnson 2010)

- A few additional slides on interest deductibility

What is wrong with interest deductibility?

- A massive issue in base erosion and profit shifting
- Chevron (and other) transfer pricing cases show related party debt highly manipulable
- Hybrids, double dips
- ATO: Cross-border related party financing and "red zone"

The ATO "red zone" of related party x-border financing for large corporates



AFR, Jul 16 2017
http://www.afr.com/news/policy/tax/atos-finance-ruling-puts-companies-the-red-zone-20170711-gx90bm

Surely this indicates a *systemic* policy problem?

Interest deductibility may be bad for macro stability

- Aim to curb excessive private leverage
  - Amplified by tax distortions
- De Mooij and Hebous (2017 IMF WP)
  - Thin cap limits for related party debt have no effect on debt leverage of firms
  - Need broader limits on interest deductibility for all debt, to have an effect
- Same argument has been made for negative gearing at individual level

Trump plan

- Lower headline rate to 15%
- Full expensing of capital investment
- Eliminate interest deductibility
- *But of course, many say it won't happen…*
  - *(Although Moody's last week say administration will "renew efforts to reform US corporate tax laws with fresh vigor")*
  - *https://www.moodys.com/research/Moodys-Benefits-of-US-tax-reforms-would-accrue-mainly-to--PR_369989*
- History: US 1992; US President's Advisory Panel 2005

Other international moves or support limit/constrain interest deductibility

- OECD BEPS Action 4 seeks to limit interest deductibility (tighten thin cap)
- UK (since April 2017), Germany, Greece, Italy, Norway, Portugal, Spain have 30% of taxable EBITDA (profits) cap on interest deductibility for large corporates
- EU limits for interest deductibility include denying deductibility for hybrids

But: significant support to retain interest deductibility

- Business Tax Working Group (2012) failed to get corporate consensus on broadening CT base to lower the rate including on thin capitalisation

- Treasury (2016) Sub to Senate inquiry supported interest deductibility
  - "The ability for the business to borrow funds and deduct the interest and other expenditure against assessable income significantly benefits the business, provides an incentive for investment and positively benefits the economy. Without the ability to deduct the cost of expenditure, some profitable investments may happen in other jurisdictions or not at all… [Such a model] has been mooted in academic literature… this model would increase the cost of capital… [Any such change] must be carefully considered (Treasury 2015 p10-11).

Thanks!

Questions?