TTPI

TAX AND TRANSFER POLICY INSTITUTE

Corporate income taxation in Australia

Theory, current practice and future policy directions

Executive Summary

Since its introduction at the federal level more than a century ago, the corporate income tax has undergone reforms and modifications enacted in response to changes in economic conditions both domestic and global, the design of other tax policies and rates, and political and revenue pressures. These changes were implemented through the statutory tax rate, but also through the definition of the tax base, depreciation allowances, tax concessions, the treatment of dividends, capital gains and fringe benefits, and differentiation by company size, among others. Over time they have added complexity, created loopholes, and amplified inequities across companies and different income streams.

For decades, Australian taxation experts have maintained that from an economic welfare (or efficiency) standpoint, Australia stands to gain markedly from reform of one of its most damaged and damaging taxation regimes. Productivity growth has been weak since a peak during the mining boom in 2012 – 13 and the design of the current corporate income tax system contributes to that weakness. Productivity growth drives economic growth and improvements in living standards. By improving investment conditions and the attractiveness of investing in Australia, corporate tax reform can contribute to productivity improvements.

This report provides a framework for policy analysis of the corporate income tax system in Australia to broaden understanding of the topic and heighten policy debate. It achieves this by tackling three questions:

- What are the main problems (distortions) associated with the current corporate income tax system (chapter 2)?
- What policy options could be implemented in Australia to redress these problems (chapter 3)?
- What is the best policy option (chapter 4)?

This report argues that the introduction of an Allowance for Corporate Equity (ACE) is the best approach for corporate income tax reform. It also addresses how neither a *decrease in the headline corporate tax rate* nor the introduction of *accelerated depreciation* (or an investment allowance) — the two corporate tax "reform" proposals most commonly bandied-about in Australia — represent effective reform. Both policies retain the system's pre-existing distortions. Decreasing the headline corporate rate in isolation could improve investment in the long-run, but provides a windfall gain to existing equity investors. Similarly, while investment allowances and accelerated depreciation spur investment in the short-run (but not necessarily the long-run), they tend to favour specific industries.

Finally, the report includes several appendices which discuss: the difference between the "normal" return to investment and economic rents; the history of corporate income taxation in Australia; an overview of how the Commonwealth and states and territories tax natural resources; an overview of methods used to calculate effective corporate tax rates; a detailed explanation of how the imputation system works in practice and its losers and winners; and a review of Australia's two sectoral cash-flow taxes, the Petroleum Resource Rent Tax (PRRT) and the Northern Territory's Mineral Rent Tax.

What are the main problems associated with the current corporate income tax system?

Using economic theory and empirical research drawn from the domestic and international literature, chapter two identifies seven economic problems (distortions) inherent in the design of the current corporate income tax (**Table 1**). These problems compromise the efficiency and fairness of the system, harm investment, and constrain economic growth. Exacerbating these seven problems is a corporate tax system that has grown increasingly complex. While these and similar problems have been actively studied and debated globally, this report provides insight to their importance in the Australian context.

Table 1. Summary of the problems associated with the current corporate income tax system

Problem	Summary	Consequence
1. Gap between the statutory corporate income tax (CIT) rates and personal income tax (PIT) rates	The corporate tax rate (25 per cent for small companies and 30 per cent for large companies) is substantially lower than the highest marginal tax rate (47 per cent) in the personal income tax system.	Paying marginal PIT at a rate higher than the CIT rate incentivises individuals to incorporate whenever the CIT rate is lower. This creates inefficiencies and inequities. Businesses operated through trusts can leverage arbitrage opportunities between the CIT rate and all beneficiary PIT rates lower than the CIT rate (including the tax-free threshold). These arbitrage possibilities are used by individuals to split income across individuals in one financial year and across different financial years (deferral benefits). This distortion compromises the tax revenue base and the efficiency and fairness of the tax system.
2. Debt bias	Firms are not taxed on debt financing expenses (interest payments) because these costs are recognised by the tax system as legitimate business expenses and are deductible. However, the cost of equity financing, an alternative to debt, is not recognised.	Incentivises firms to use debt. Increases risk of bankruptcy. Over-reliance on debt is not apparent to a large extent in Australian data. However, this could be a large concern for MNEs, for which data are limited.
3. Taxing the normal return to investment	Since the cost of equity financing is not recognised by the tax system, firms that use equity financing need to make more than the normal return on investment to remain viable.	Reduces the ability for marginal firms (those just breaking even) to exist (since they cannot expense all of their costs). More profitable firms do not invest as much as they would in the absence of the tax. A tax system which reduces investment discourages productivity and economic growth.

Problem	Summary	Consequence
4. High statutory corporate income tax rate	Australia's corporate tax rate is higher than most OECD countries and geographic neighbours.	The high corporate income tax rate increases the pre-tax return firms must obtain to meet global investors' expected return on investment. This lowers foreign investment in Australia and encourages Australian firms to invest overseas. Even if corporate tax only applied to economic rent, it could still discourage foreign investment in Australia where those rents are mobile (see **Appendix A** for a discussion of economic rents). Lower investment leads to less productivity and slower economic growth. The relatively high statutory corporate income tax rate incentivises large MNEs to issue debt to their Australian subsidiaries. This compromises the tax revenue base.
5. Variation in effective corporate tax rates	Effective corporate tax rates, which take into account the actual tax rate paid by companies, differ from the headline corporate rate and can influence investment decisions. Effective tax rates vary substantially across different types of investments.	The effective tax rate applied to specific investments varies depending on the financing a company uses, how depreciation is applied, and how other tax system design features (such as concessional treatment) apply. While these features may be appropriate (lower tax rates on R&D have positive spill over effects), the wide variation compromises efficiency and exacerbates incentives to invest in certain assets using a specific type of funding even when this may not be economically efficient.
6. Differences between economic and tax depreciation	Differences between tax and economic depreciation benefit some firms and cost others. For example, if an asset's tax depreciation is less than its economic depreciation, a firm cannot deduct full costs from its taxable income.	Differences between economic and tax depreciation result in a tax on the normal return on investment for some firms and a subsidy to investment for others. It has an ambiguous effect on investment because it depends on the composition of taxed to subsidised firms.
7. Imputation system	The imputation system subsidises domestic investment.	The imputation system encourages Australian companies to distribute dividends. The imputation system encourages investors to make investments based on tax design, deterring them from opportunities that give them the best return (based on their risk and liquidity preferences). Evidence suggests eliminating the imputation system would: (1) neither harm nor encourage investment ("new view" explanation) or (2) only directly affect investment into cash-constrained domestic firms that rely heavily on domestic shareholders ("agency" theory explanation). Elimination of imputation would likely reduce the degree of home bias in the portfolios of Australian investors.

What policy options could be implemented in Australia to redress these problems?

A review of leading options for reform, including a comprehensive business income tax (CBIT), allowance for corporate capital (ACC), allowance for corporate equity (ACE) and cash-flow tax (CFT), is presented in **Table 2** and **Table 3**. These options are evaluated against their ability to resolve the seven problems identified in chapter two. Reform should also look to simplify the overall system.

Table 2. Summary of the problems addressed by the different approaches to corporate income taxation (assuming revenue neutrality within the corporate tax system)

Problem	Does this system resolve the problems of the current system:			
	CBIT	**ACE**	**ACC**	**CFT (pure, not modified)**
1. Gap between the statutory corporate income tax (CIT) rate and personal income tax (PIT) rates	No, it is worsened. The gap gets bigger because the CBIT broadens the tax base and the corporate tax rate can be lowered. Arbitrage opportunities through the use of trusts and the lower PIT rates remain.	Yes, partially. The gap between the highest PIT rate and the CIT rate is reduced because the CIT rate increases. However, arbitrage opportunities remain through the use of trusts and the lower PIT rates.	Uncertain. It is not possible to determine whether a revenue neutral ACC rate would go up or down.	Yes, partially. The gap between the highest PIT rate and the CIT rate is reduced because the CIT rate increases. However, arbitrage opportunities remain through the use of trusts and the lower PIT rates.
2. Debt bias	Yes. All financing costs are excluded from the tax base.	Yes, partially. The normal return to equity is recognised as a financing cost. However, since the normal return to equity may vary by firm, the notional return to equity designated in the ACE will be more generous to some firms and less generous to others. The ACE will lessen but not eliminate the bias.	Yes	Yes.
3. Taxing the normal return to investment	No, it is worsened. Since no financing costs are recognised as an expense incurred by businesses, running a business is more costly. Taxation of the normal return to investment can be reduced, for equity financed investments, by a reduction in the statutory corporate tax rate.	Yes, partially. See comment above about the normal return to equity varying by firm.	Potentially. The normal return to equity and debt are recognised as a financing cost. However, since the normal return to both debt and equity may vary by firm, the notional return designated in the ACC will be more generous to some firms and less generous to others. The ACC will lessen the bias but not eliminate it.	Yes.

Problem	Does this system resolve the problems of the current system:			
	CBIT	**ACE**	**ACC**	**CFT (pure, not modified)**
4. High statutory corporate income tax rate	Yes. If MNEs cannot write-off their debt as a cost, they have less incentive to allocate it to a high tax country such as Australia. A revenue neutral change to a CBIT would allow a reduction in the statutory corporate income tax rate.	No. Other regulation will be required to redress this issue. A revenue neutral ACE with a higher rate could encourage MNEs to shift more debt to Australia. It could also encourage MNE's to double-dip tax deductions through Australia.	No. Other regulation will be required to redress this issue.	No. Other regulation will be required to address this issue. A revenue neutral CFT with a higher rate could encourage MNEs to shift more debt here, but it is hard to know since the tax system would be entirely different. Concern about future tax evasion arises where companies structure large investment cash outflows in Australia and declare future cash inflows from those investments in other countries.
5. Variation in effective corporate tax rates	Yes, partially. Variation caused by differences between tax and economic depreciation will remain. Variation caused by differences in financing will be eliminated. Variation induced by explicit policy choices to incentivise certain types of investment (like R&D) will remain.	Yes, mostly. Variation caused by differences in economic and tax depreciation will be partially eliminated. Variation caused by differences in financing will be partially eliminated. Variation induced by explicit policy choices to incentivise certain types of investment (like R&D) will remain.	Yes, mostly. Variation caused by differences in economic and tax depreciation will be eliminated. Variation caused by differences in financing will be eliminated. Variation induced by explicit policy choices to incentivise certain types of investment (like R&D) will remain.	Yes.
6. Difference between economic and tax depreciation	No. Identical treatment to the current corporate income tax system	Yes, partially. A difference will remain however, if the actual return to equity differs from the allowance rate for corporate equity.	Yes.	Yes.

Table 3. Impact of different approaches to corporate income taxation on shareholders and bondholders

Problem	Does this system resolve the problems of the current system:			
	CBIT	**ACE**	**ACC**	**CFT**
Impact on shareholder dividends	Identical treatment to the current corporate income tax system	If the imputation remained, as it currently operates, shareholders would only receive franking credits for the portion of the dividend which had been taxed at the corporate level (the economic rents). In general, a rethink of the imputation system's operation would be desirable if an ACE were introduced.	If the imputation remained, as it currently operates, shareholders would only receive franking credits for the portion of the dividend which had been taxed at the corporate level (the economic rents). In general, a rethink of the imputation system's operation would be desirable if an ACC were introduced.	The imputation system would require reform.
Impact on corporate bondholders' return on investment	No, it is worsened. The marginal tax on interest payments received by bondholders will increase with additional taxation at the corporate level.	Identical treatment to the current corporate income tax system	If the ACC 's notional return to capital is set lower than the interest rate owed on a corporate bond, part of the bondholder's return will be taxed at the corporate and shareholder level. In general, a rethink of the taxation of interest would need to be considered if an ACC was introduced.	Identical treatment to the current corporate income tax system

The best policy option: An allowance for corporate equity (ACE)

Relative to a CBIT, ACC and CFT, this report recommends the introduction of an Allowance for Corporate Equity (ACE) for three principal reasons.

An ACE resolves or attenuates problems inherent in the design of the current corporate income tax system

- It stimulates investment by reducing the marginal effective tax rate on investment (in some cases to zero).
- It reduces the "debt bias" in investment decisions by granting a deduction for the cost of equity financing.
- It eliminates most variation in effective corporate tax rates across different investments.
- It is insensitive to depreciation methods and would enable a radical simplification of the current schedule.
- It is insensitive to inflation as higher nominal profits are offset by a higher allowance for corporate equity.

As the only option implemented at a national level, Australia can draw on the international ACE experience and research

- Evidence suggests the introduction of an ACE increases investment, possibly with heterogenous effects on active and passive investment. An ACE also reduces firm leverage.

Implementation and transitional costs of an ACE are lower than an ACC, CBIT or CFT

- The ACE resembles the current corporate income tax system, augmented with an extra deduction for the cost of equity. Both the CBIT and ACC are also similar in design to the current system. By contrast, the introduction of a CFT would change the tax base and result in the potential for companies' double-taxation and increased tax evasion (and tax revenue loss).
- An ACE does not change the existing treatment of debt. By contrast, the CBIT, ACC, and CFT (under an R-base) alter the deductibility of debt, thereby presenting transitional and financial challenges for highly leveraged firms. While a CFT with an R+F base retains debt interest deductibility, it still requires a change in the tax base (noted above).
- The current system of depreciation could remain the same under an ACE, ACC or CBIT. It could also be simplified under an ACE. Under a CFT, depreciation would be eliminated and its introduction would require transitional measures to account for companies' un-deducted depreciation allowances.
- The potential for companies' double-taxation, increased tax evasion, and the high transitional costs associated with the deductibility of debt and un-deducted depreciation allowances were among the reasons both New Zealand and Norway opted against introducing a national CFT.

In summary, unlike the ACC, CBIT and CFT, the introduction of an ACE achieves the goal of stimulating investment, with minimal implementation and transitional costs, and with scope for simplification of some aspects of the current system, namely depreciation. By contrast, while a CFT will also spur investment, transitional costs are substantive and feature among the reasons other countries have opted against introducing one at the national level. While an ACC and CBIT more closely align to the design of the current system, they will both have transitional costs associated with disallowing some or all of debt interest. In addition, a CBIT could discourage investment by increasing the cost of capital. An ACC's impact on investment, will depend on its design.

However, an ACE will not in isolation resolve all challenges associated with corporate taxation. The value of integrating personal and corporate income tax levels to maintain revenue neutrality while implementing an ACE is diminished because of arbitrage opportunities, which could be addressed with a review of hybrid business structures, such as trusts. In addition, some economic rents are mobile. If firms that make economic rents have discretion regarding their location, a lower corporate tax rate is a stronger incentive for relocation than an ACE.

ACE Implementation considerations

Should Australia introduce a hard (all equity) or soft (new equity) ACE?

A soft ACE – the recommended approach for Australia - only recognises new equity, as opposed to a company's entire stock of equity. Global tax reform experience suggests introducing a modest reform, such as a soft ACE, and gradually strengthening it over time is typically more successful. A soft ACE more closely resembles the existing system than a hard ACE (which recognises all equity) and is less costly to implement. Restricting the base to new equity also encourages new investment and eliminates windfall gains to existing equity investments.

At what rate should the notional return to equity be set?

The ACE rate should be set at the 10-year government bond rate. This rate is comparable to that of other countries and should be adjusted annually to avoid misalignment with the long-term rate. Losses should be uplifted at the ACE rate and offset against future liabilities. Alternatively, to reduce the risk of unused losses, losses incurred in a given year could be applied against other tax liabilities such as the goods and services tax (GST), pay as you go tax (PAYG), and fringe benefits tax (FBT).

In addition, an ACE rate for small and medium enterprises (SMEs) should be set at 0.5 percent higher than the rate for larger companies. This increase is a risk premium associated with the higher probability of SMEs going bankrupt (and being unable to use the ACE allowance).

The lower corporate income rate applicable to smaller businesses should be removed and the rate standardised at 30 percent for all companies. While this increases the rate that applies to small businesses, it would apply to a smaller corporate tax base. SMEs will typically benefit more from a higher ACE rate as a lower tax rate only benefits companies with positive taxable income, less likely amongst SMEs, in particular start-ups and growth companies. A higher ACE rate and loss carry forward provisions will assist small businesses to earn a normal return, encourage capitalisation, and stimulate investment.

How could an ACE be financed?

Although an ACE narrows the corporate income tax base, the statutory corporate income tax rate should not be increased. Raising the statutory rate increases effective corporate tax rates, deters inward investment, encourages outward profit-shifting, negatively affects the investment decisions of cash-constrained firms, and discourages companies able to choose the location of their investments from investing in Australia.

If revenue neutrality is desired it could be achieved through other means, such as:

- Debt-financing, particularly given the current low interest rate environment and investment benefits expected from the reform;
- An increase in the GST. Research suggests that the increase in investment induced by the introduction of an ACE is amplified if revenue neutrality is financed from a change in the GST, instead of an increase in the statutory corporate tax rate. Australia's GST is low relative to other OECD countries;

- Reform of the imputation system. Depending on the design of reform, this could be revenue neutral or revenue positive. Part of the argument in favour of retaining the imputation system relates to the lower levels of firm leverage observed in Australia following its introduction. An ACE lowers levels of firm leverage. In so doing it weakens the argument for retaining the imputation system as the loss of any effect imputation has in reducing leverage can be offset with an ACE; or
- Simplification of the existing corporate tax and transfer system including reduction or elimination of concessional measures directed at business.

Concluding remarks

While the introduction of an ACE will contribute to a more dynamic investment environment in Australia, it still falls short of the system-level reform of the tax and transfer system that has been repeatedly called for by this and other reports. Systemic and comprehensive tax reform would integrate corporate income tax reform with reform of the broader tax and transfer system, explore interactions across the different tax rates and tax bases, and assess the cumulative inter-related effects of these interactions on the overall system. In turn, this type of broader reform would accelerate Australia's future economic prospects and enhance the well-being of Australians. While this report focuses on the corporate tax system, ideally its recommendations – and those of TTPI's other reports in this series (e.g. Varela et al. 2020 on the taxation of savings) – should be considered and implemented in the context of this long-called-for comprehensive tax reform in Australia.

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