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### Australia's company tax: options for fiscally sustainable reform, updated post Trump

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#### Abstract

The Australian Government proposes to reduce the company tax rate from 30 to 25 per cent. However, there are widespread concerns that the fiscal cost is not affordable. This paper considers alternative reforms of corporate taxation that could fund a corporate tax rate cut. We address key non-neutralities in the corporate tax system and consider key international developments, including the enactment of the Trump tax plan in the United States, which lowers the US corporate tax rate to 21%. We examine the case for abolition of dividend imputation in favour of a lower headline company tax rate and consider the spectrum of reform options for the corporate tax base, which ranges from the cash flow tax and allowance for corporate equity or capital to a comprehensive business income tax which would eliminate interest deductibility. These measures (which could co-exist in a hybrid system) might be accompanied by discounts on dividend and interest income at the personal level, in replacement of dividend imputation.

**NOTE:** This paper supersedes WP9/2017 on Australia's company tax, and takes account of revised modelling by C Murphy incorporating the recent US company tax cuts and published as WP2/2018.

Keywords: Corporation tax, tax policy, dividend imputation, allowance for corporate equity, allowance for corporate capital, cash flow tax, rent tax, comprehensive business income tax

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## 1. Introduction

The Australian government proposes a reduction in the corporate tax rate from 30 per cent to 25 per cent on the grounds of increased investment and productivity in a globally competitive environment.<sup>1</sup> The proposal is contentious and there is significant political opposition. Yet it is clear that corporate tax rates are coming down around the world, most recently in the US. The OECD identifies ‘intensifying’ competition on corporate income tax rates through staged multi-year rate cuts and the occasional sudden rate reduction.<sup>2</sup> We discuss alternative options, and potential combinations of them, to finance a cut in the corporate tax rate in Australia. We conclude by suggesting fiscally sustainable directions for reform.

Today, many comparable countries to Australia have reduced their corporate tax rate below 30 per cent as shown in Figure 1. Countries that have lower corporate tax rates include the United Kingdom (20 per cent with a planned reduction to 17 per cent); China (25 per cent); Canada (26.5 per cent); Ireland has long had a low rate of 12.5 per cent for business income. Japan’s rate is currently 30.86 per cent, Germany 29.72 per cent, India 30 per cent and France 33.3 per cent. The United States (US) until recently had the highest rate at 35 per cent; the latest Republican Tax Framework proposed a corporate tax rate of 20 per cent, and a 21 per cent rate was enacted. The US will also replace the foreign tax credit worldwide system with an exemption system of international tax. These developments have important implications for Australia. Many countries have also enacted lower rates and concessions for particular investments and activities, especially intellectual property.

This article presents a range of corporate tax base reform options and modelling estimates of the economic benefits and fiscal cost of these different options, to facilitate policy debate about the future design of Australia’s corporate tax. In developing these options, we draw on the large theoretical, policy and empirical literature on the corporate tax and refer to developments in corporate tax reform around the world.<sup>3</sup> The options we discuss address, in particular, the non-neutrality in the existing corporate tax between debt and equity financing of corporations in a cross-border context.

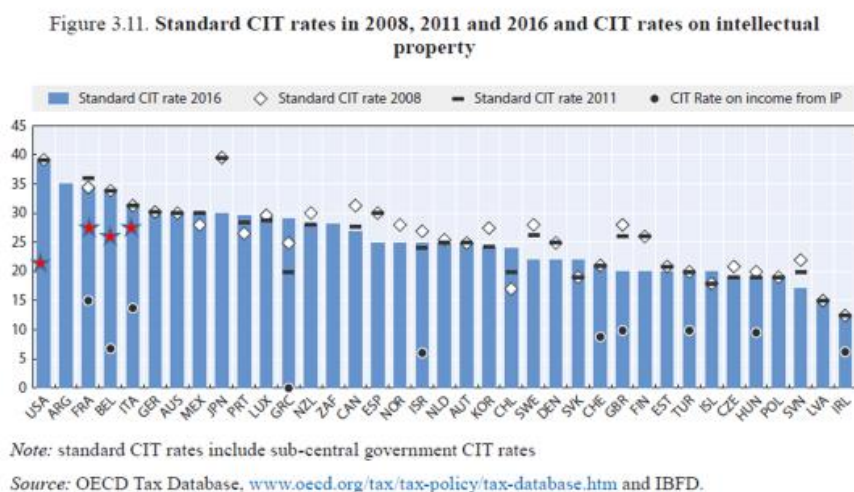
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<sup>1</sup> *Treasury Laws Amendment (Enterprise Tax Plan) Act 2017* and *Treasury Laws Amendment (Enterprise Tax Plan No. 2) Bill 2017*.

<sup>2</sup> OECD, *Tax Policy Reforms 2017: OECD and Selected Partner Economies* (2017) OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264279919-en>, p. 11.

<sup>3</sup> The literature, theory and goals of the corporate tax are explored in detail in Ingles, D *What future for the corporation tax?* (2017) TTPI WP 3/2017.

**Figure 1: Corporate tax rates in the OECD, 2008, 2011, 2016 (OECD, 2017)**



Note: Asterisks show enacted reductions in tax rates since 2016 in the United States, France, Italy and Belgium

Economic modelling in Australia and internationally suggests that the corporate tax has a high marginal excess burden (MEB) relative to other taxes and hence this modelling provides support for cutting the corporate tax rate at least to 25 per cent and possibly 20 per cent.<sup>4</sup> In a companion article in this volume, modelling by Chris Murphy<sup>5</sup> indicates that the corporate income tax has a high MEB of 104 per cent or \$1.04 for the marginal dollar raised. The modelling provides strong support for a rate cut to 25 per cent, estimating that this would produce a \$4.9 billion net consumer welfare gain for a \$4.7 billion annual fiscal cost; support for cutting the rate further to 20 per cent (a \$3.9 billion welfare gain with a \$5.7 billion annual fiscal cost); and weaker support for going to 15 per cent (\$2.9 billion welfare gain with a \$6.5 billion annual fiscal cost).

In the economic and policy debate in Australia, there are different views about the economic benefit to Australians from a corporate tax rate cut.<sup>6</sup> A particular concern is

<sup>4</sup> Murphy, C 'Company tax scenario' Report prepared for the Department of the Treasury by Chris Murphy, Director, Independent Economics and Visiting Fellow, ANU (28 April 2016); Murphy C 'The economic impact of the company tax cut' *Austaxpolicy blog* (9 May 2016); Murphy, C 'Efficiency of the tax system: a marginal excess burden analysis' (2016) TTPI WP 4/2016.

<sup>5</sup> Murphy, C, 'Modelling Corporate Tax Reforms' (2018) *Australian Tax Forum* forthcoming. The updated detailed results and modelling parameters are explained in Murphy, C 'Modelling Australian Corporate Tax Reforms' (2017) TTPI Working Paper 2/2018 and 8/2017. The authors worked with Chris Murphy to develop jointly a set of corporate tax policy reform options covering tax bases ranging from the ACC or ACE to the CBIT, the removal of imputation and the choice of tax rate, so as to investigate their different efficiency and revenue effects in the Australian context.

<sup>6</sup> Dixon J and Nassios J 'Modelling the impacts of a cut to company tax in Australia' Centre of policy studies, Victoria University G-260 (April 2016). Note that Dixon and Nassios agree with Murphy on the positive GDP effect for Australia but disagree on the overall effect for consumer welfare. There

the fiscal affordability of a rate cut. Corporate income tax raises about \$70 billion each year.<sup>7</sup> The budget impact of the phased corporate tax rate cut to 25 per cent was estimated to be \$48 billion over 10 years to 2026-27, consistent with a Parliamentary Budget Office estimate of \$51 billion over that period; this equates to approximately \$8 billion per annum.<sup>8</sup> On the other hand, there are potential economic offsets which in the long run can reduce the net costs by around half; this is taken into account in the modelling, but not in the budget estimates. The budget effect is a key reason for political opposition to the rate cut in Australia, as the federal government is in its tenth year of a federal deficit.

In 2012, the Treasury established a Business Tax Working Group which investigated financing the corporate tax rate cut with base broadening.<sup>9</sup> The group, which included government officials, academics and business representatives, considered a range of options but did not succeed in reaching a consensus. Nonetheless, we argue that the design of the corporate tax base, and the corporate-shareholder imputation system, must be re-examined to clearly identify Australia's policy options.

Corporate tax base options in the literature range from the cash-flow tax (or business level expenditure tax); cash flow-equivalent taxes such as the allowance for corporate equity (ACE) or allowance for corporate capital (ACC); to the broad-based comprehensive business income tax (CBIT). At one end of the spectrum, the cash-flow tax, ACE and ACC narrow the corporate tax base by providing a deduction for the present value of investment costs but do so in different ways. These taxes apply to economic rents and exempt the 'normal' return to capital from tax. Modelling suggest that for a given tax rate they are more efficient. However, they require a higher tax rate for a given revenue, or financing from other taxes, and this can undermine efficiency when governments are fiscally constrained. These narrow-based taxes also potentially exacerbate incentives for base erosion and profit shifting (BEPS) by gaming of deductions or allowances in an international context.

At the other end of the spectrum, the CBIT broadens the corporate tax base by eliminating interest deductibility and it can thereby fund a lower tax rate. However, it levies a tax on the normal return to capital (albeit at that lower rate) and is therefore less efficient. An alternative part-way along the spectrum is limits to interest deductibility that do not fully deny that deduction, such as stronger thin capitalisation rules, or a withholding tax on cross-border interest and other financial flows. All these

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are also different views about whether we would really benefit from a corporate tax rate reduction, especially taking account of effects on the personal income tax system, and doubts about the importance of international tax competition and profit shifting.

<sup>7</sup> Australian Treasury *Re:think - Tax Discussion Paper* (2015), Chart 2.6 p. 21, available from <http://bettertax.gov.au/publications/discussion-paper/> (accessed 6.10.17) (***Re:think Discussion Paper***).

<sup>8</sup> Australian Treasury (2016) Budget Paper No 1, available from [www.budget.gov.au](http://www.budget.gov.au) ; Parliamentary Budget Office <http://www.abc.net.au/news/2016-06-01/pbo-says-corporate-tax-cuts-to-cost-51b-over-10-years/7468472> (accessed 6.10.17). The base modelling assumption is that a corporate rate cut is financed with a "lump sum" tax but this is not a practical option. In reality, the fiscal cost of cutting the rate must be funded from other taxes or debt and this can reduce the net welfare benefit.

<sup>9</sup> Australian Treasury (2012), *Business Tax Working Group Final Report*, available from <https://treasury.gov.au/publication/business-tax-working-group-final-report/business-tax-working-group-final-report/> (accessed 6.10.17).

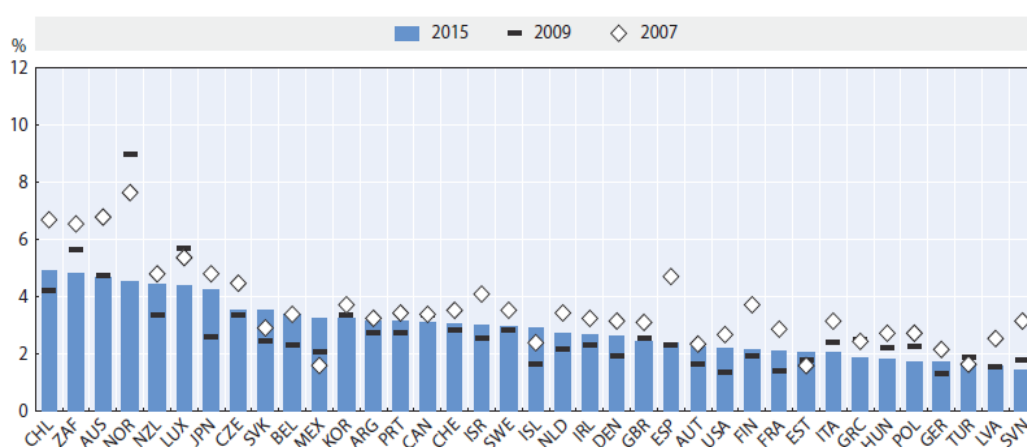
alternatives pose challenges for the integration of the corporate-level system with the personal income tax system for shareholders, or capital in general.

## 2. Australia's corporate tax and dividend imputation

It is important to analyse reform options in the context of Australia's unique corporate and international tax system for business profits. Australia's \$70 billion per year in corporate tax is about 6 per cent of GDP, 15 per cent of total government revenue<sup>10</sup> and 19 per cent of Commonwealth government revenue.<sup>11</sup> This is an unusually large share of revenue compared to the OECD average of 8.5 per cent, or just below 3 per cent of GDP, as shown in Figure 2.<sup>12</sup> However, this difference is not as dramatic as it appears once Australia's dividend imputation system is taken into account.<sup>13</sup>

**Figure 2: Corporate tax level in the OECD (OECD, 2017)**

Figure 3.9. CIT revenues as a share of GDP by country



Source: Regional Revenue Statistics databases ([www.oecd.org/tax/tax-policy/revenue-statistics-comparable-tax-revenue-data.htm](http://www.oecd.org/tax/tax-policy/revenue-statistics-comparable-tax-revenue-data.htm)).

TAX POLICY REFORMS 2017: OECD AND SELECTED PARTNER ECONOMIES © OECD 2017

### 2.1. Design of the dividend imputation system

Dividend imputation was designed on a 'closed economy' assumption about investment. Today, it is more appropriate to consider Australian corporate-shareholder tax policy as being set in a 'small open economy' context, in which it is assumed that the rate of return is set globally and the marginal investor is foreign. We discuss that approach in part 2.2.

Australia adopted dividend imputation in 1987, following a trend in the United Kingdom, Europe, New Zealand and elsewhere. Under dividend imputation, the

<sup>10</sup> Australian Bureau of Statistics (ABS) 5506.0 - Taxation Revenue, Australia 2015-16 (2017). This measures income taxes on enterprises, including taxation of superannuation funds.

<sup>11</sup> *Re:think Discussion Paper*, above n 7, Chart 2.6 p.21 shows 22 per cent; this heading - taxation of entities – includes taxation of superannuation funds of approximately \$7 billion per year leaving the company tax take at about \$70 billion.

<sup>12</sup> *Re:think Discussion Paper*, above n 7, Chart 5.3 p.76.

<sup>13</sup> Ingles (2017), above n 3, p. 4.



corporate tax is converted into a withholding tax that is creditable against the shareholder tax due on dividends. The ultimate tax burden is the same as if the shareholders had earned the business income directly. The imputation credit is distributed to shareholders with a 'franked dividend'; the dividend is grossed up and the credit is offset against individual income tax payable. Imputation credits are refundable for those individual taxpayers who have a tax rate below the corporate tax rate and superannuation funds (it should be noted that New Zealand's imputation system does not include a refundable credit). A return of capital or sale of the share is subject to capital gains tax, usually at a discount, and does not carry imputation credits. Dividend imputation is only applicable for resident shareholders and Australian taxed profits. It is not available for foreign shareholders and nor is it available for foreign profits not taxed in Australia.

As a consequence of dividend imputation, the most relevant tax for individual investors is the personal income tax (including the capital gains tax) and not the corporate tax. The corporate tax can be thought of as a sort of random withholding tax at the company level, offset against personal income tax at the individual level.<sup>14</sup> As a result of dividend imputation, distortions in the company tax (such as difficulties in accurately measuring profits) and the exemption for foreign business profits, as well as concessions such as the Research and Development tax concession, are washed out by the combined corporate and personal income taxes.

Assuming a closed economy, dividend imputation has several advantages. In a domestic investment context, it reduces the bias that exists in a 'classical' tax system towards companies retaining their profits, rather than distributing them to shareholders as dividends.<sup>15</sup> It also eliminates the bias for domestic investors against equity and towards debt. One reason for the introduction of imputation was a significant decline in corporate tax revenues relative to GDP in Australia from the 1970s, as a result of tax planning to avoid the 'double tax' on corporate profits. Corporate tax revenues increased again after the introduction of dividend imputation.<sup>16</sup> However very few countries now operate imputation systems.

## 2.2. *The open economy view and the marginal foreign investor*

On the assumption of an open economy, dividend imputation embeds several distortions. Australia has always limited the imputation credit system to resident investors and to domestic tax profits. Since 2004, Australia has had a territorial (exemption) system for foreign business profits. Therefore, a different result follows for foreign investors into Australian corporations. It is estimated that one-third of Australian equity is foreign owned.<sup>17</sup> Dividend imputation as it interacts with

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<sup>14</sup> Sorensen, P and Johnson, S 'Taxing capital income: options for reform in Australia' in *Melbourne Institute Australia's future tax and transfer policy Conference: Proceedings* (2010) p. 205 (available from [https://taxreview.treasury.gov.au/content/Content.aspx?doc=html/conference\\_report.htm](https://taxreview.treasury.gov.au/content/Content.aspx?doc=html/conference_report.htm)).

<sup>15</sup> Australian Treasury, Henry Tax Review *Australia's Future Tax System Review, AFTS Final Report*, (2010) Australian Government: Canberra, available from <https://taxreview.treasury.gov.au>.

<sup>16</sup> See Australian Treasury *Draft White Paper* (1985) Chart 17A.1, p. 192 for earlier corporate tax revenues.

<sup>17</sup> Freebairn, J 'Who Pays the Australian Corporate Income Tax?' (2015) *The Australian Economic Review*, vol. 48, no. 4, 357–68; Minifie, J *Stagnation nation? Australian investment in a low-growth world* (2017) Grattan Institute, p. 28-29, available from <https://grattan.edu.au/report/stagnation-nation/> (accessed 6.10.17) (**Stagnation Nation?**).

Australia's international tax system effectively retains a 'classical' system for non-residents.<sup>18</sup> This generates a bias between debt and equity for investment in Australian companies.

Australia's dividend imputation system also discourages outbound investment by Australian companies because imputation does not offer relief from underlying foreign corporate taxes. This creates a bias against Australian-owned companies investing in foreign companies or engaging in foreign business activities.

A franked dividend paid to a foreign investor effectively 'wastes' the imputation credit but is exempt from dividend withholding tax which for other income currently varies from zero to 30 per cent depending on whether there is an applicable tax treaty. Because of imputation, a company tax cut is far more valuable for foreign investors than to domestic investors.<sup>19</sup>

The withdrawal of the UK and many European countries from imputation systems was a result of constraints from the European Union (EU) requirement for the free movement of capital and not for tax policy reasons. Some scholars from other countries (including the US) view Australia's dividend imputation system favourably, citing its tax integrity benefits and elimination of debt-equity distortions (albeit only domestically).<sup>20</sup> It appears to encourage Australian companies with significant Australian shareholders to pay Australian corporate tax, as tax avoidance by Australian companies reduces their ability to pay franked dividends.<sup>21</sup> However, on the open economy view, any revenue benefit is swamped by the much larger loss of revenue arising from providing imputation benefits to domestic investors.

There is debate about the effect of imputation on equity markets and the pricing of imputation credits for investors.<sup>22</sup> Imputation credits may be only partially priced in the market.<sup>23</sup> It appears that dividend imputation has affected behaviours of companies and investors in ways that are often suggested to be positive for capital

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<sup>18</sup> As noted by the Review of Business Taxation, *A Tax System Redesigned* (1999), paras 240-243, available from <https://rbt.treasury.gov.au/> (accessed 6.10.17).

<sup>19</sup> *Stagnation nation?* Above n 17, p. 57 calculates that a 5 percentage point corporate tax rate cut would increase the rate of return to foreign shareholders by 7 per cent and to domestic shareholders by 2 per cent.

<sup>20</sup> Graetz, M and Warren, A 'Integration of Corporate and Shareholder Taxes' (2016) *National Tax Journal* 69:3, 677-700 DOI: dx.doi.org/10.17310/ntj.2016.3.07; Toder, E and Viard, A 'Major Surgery Needed: A Call for Structural Reform of the U.S. Corporate Income Tax' *Urban-Brookings Tax Policy Centre Working Paper* (April 2014); Kleinbard, E 'The Trojan Horse of Corporate Integration', Featured Article, *Tax Analysts* (August 15, 2016), <http://www.taxanalysts.org/content/trojan-horse-corporate-integration> (accessed 6.10.17).

<sup>21</sup> See, e.g., Ikin, C & Tran, A 'Corporate Tax strategy in the Australian dividend imputation system', (2013) *Australian Tax Forum* vol. 28, no. 3, 523-553; Tran, A & Yu, Y 'Effective Tax Rates of Corporate Australia and the Book-Tax Income Gap' (2008) *Australian Tax Forum* vol. 23, no. 3, 233-268; *Re: think Discussion Paper*, above n 7, pp. 83-84.

<sup>22</sup> Bond, S, Devereux M and Klemm A 'Dividend taxes and share prices: a view from a small open economy' Institute for Fiscal Studies and ESRC (June 2009) available from [https://www.sbs.ox.ac.uk/sites/default/files/Business\\_Taxation/Events/conferences/symposia/2009/bond.pdf](https://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Events/conferences/symposia/2009/bond.pdf) ; Ainsworth, A Partington, G and Warren, G 'The impact of dividend imputation on share prices, the cost of capital and corporate behaviour' (2016) *JASSA* 1:2016.

<sup>23</sup> Ainsworth et al, *ibid.*, p. 45.



markets, including greater integrity and higher profit payout ratios, which many consider creates discipline on managers of capital.<sup>24</sup>

However, this does not take account of the cross-border effects when combined with a territorial tax system, especially for a country that remains (as does Australia) a net capital importer. The cross-border biases in Australia's imputation system are suggested by Treasury to be 'undesirable in an increasingly open and globalised world economy'.<sup>25</sup> Economic analysis of Australia as a small open economy suggests that the marginal investor is the foreign investor who allocates their worldwide investment such that the after-tax return is everywhere equal. This drives up the average return required for corporate investment; the consequent drop in inbound investment means the corporate tax is borne largely by labour and not by investors.<sup>26</sup> This view is expressed by, for example, Fuest and Huber:

'We show that, in an open economy, it is not desirable to offer double taxation relief for dividends paid by domestic firms to domestic households... The reason is that the marginal shareholder in domestic firms is a foreign shareholder. This implies that the level of real investment is not affected by the taxation of domestic dividend income at the household level. A reduction in the tax burden on dividends is therefore merely an undesirable subsidy on domestic asset holdings... which is inefficient for the economy as a whole.'<sup>27</sup>

If this is correct, it implies that abolishing imputation would reverse a 'free kick' to domestic investors, without having any adverse impact on the size or rate of return of the corporate sector. The implicit subsidy also increases the home bias of domestic taxpayers in their savings decisions, reducing outbound investment.

For example, assume the required after-tax rate of return for the foreign investor is 7 per cent. The Australian pre-tax rate of return is driven up to 10 per cent and this reduces aggregate corporate investment in Australia. When corporate tax is returned to domestic shareholders through receiving an imputation credit, anyone on a marginal rate of less than 30 per cent (including retired individuals and superannuation funds) receives an implicit subsidy for their investment. For a zero-rate taxpayer such as a retiree, the refundable imputation credit is a net subsidy relative to a 'no corporate tax' situation, which works out to be just under 43 per cent. For a superannuation fund on a 15 per cent rate, the subsidy is 21.4 per cent.

The small open economy view is of long standing in the tax literature and echoed in the work of Treasury and N. Gruen, who suggested a decade ago that if imputation were abolished, on a revenue-neutral basis the company tax rate could be reduced

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<sup>24</sup> Ainsworth et al, *ibid.*, p. 47.

<sup>25</sup> *Re:think Discussion Paper*, above n 7; Henry Tax Review, *AFTS Final Report*, Volume 1, p. 198, above n. 15. A different solution to the cross-border issues would be to extend, fully or in a more limited way, imputation credits to foreign source profits or to foreign investors, as discussed by Taylor, C J 'Dividend Imputation and Distributions of Non Portfolio Foreign Source Income: An Evaluation of Some Alternative Approaches' (2005) *Journal of the Australasian Tax Teachers Association* 1(2), 192.

<sup>26</sup> *Re:think Discussion Paper*, above n 7.

<sup>27</sup> Fuest, C and Huber, B 'The Optimal Taxation of Dividends in A Small Open Economy' Centre for European Economic Research (ZEW); CESifo (Center for Economic Studies and Ifo Institute) October (2000) *CESifo Working Paper Series No. 348*, p.2.

to between 19 and 21 per cent.<sup>28</sup> Gruen suggests that foreigners are much more responsive to changes in after-tax returns as Australian shares are a small part of their portfolios so that a small increase in the part of their portfolios directed to Australia will have a big impact on capital inflows, and notes studies suggestive that foreign direct investment would rise by between 20 and 25 per cent under a 19 per cent corporate tax rate.<sup>29</sup>

Davis by contrast uses a closed economy view. He estimates an effective corporate tax rate of 16 per cent without dividend imputation.<sup>30</sup> Davis does not advocate lowering the rate to this level or abolishing imputation but instead suggests that this should be regarded as the 'real' Australian corporate tax rate as much corporate tax is a withholding tax for the personal income tax and so the corporate tax 'burden' is a myth. It is assumed in this approach that there would be no gain to Australian investors from eliminating imputation (their tax would net out to be higher if distributions continued at the same levels). Indeed, high rate individuals would face a higher nominal tax rate on corporate distributed profit. Applying a corporate tax rate of say 19 per cent, the cessation of imputation would raise the nominal tax rate on corporate income for top marginal rate individual to 59 per cent. Low tax rate individuals would face a proportionately higher increase in their tax rate on distributed profits.

However, this high effective tax rate on equity assumes that distribution of dividends continues as under imputation.<sup>31</sup> If corporations retain earnings they can reduce the effective tax rate for investors, assuming such earnings are reinvested and produce eventual capital gains. It seems very likely that ending imputation would reduce the dividend payout ratio in Australia, which at around 75 per cent is one of the highest ratios internationally.<sup>32</sup> It would also enhance the existing incentive for Australian investors in closely held or controlled corporations to retain and defer profit in the corporation. Consequently, an undistributed profits tax as an integrity measure may be required (as Australia had in the 1970s). There may also be other investment effects, for example removing dividend imputation may exacerbate the existing

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<sup>28</sup> Gruen, N 'Tax cuts to compete: The influence of corporate taxation on Australia's economic growth', (2006) *CEDA Information Paper*, no. 85, Committee for Economic Development of Australia and Lateral Economics; 'Dividend imputation - \$20bn for the taking' SMH September 18, 2012.

<sup>29</sup> Gruen, *ibid*, p. 24.

<sup>30</sup> Davis, K 'Australia's company tax 'burden' is just a myth' *The Conversation* (October 31, 2012); Davis K 'Dividend Imputation and the Australian Financial System' (2016) *JASSA* 1:2016, 35-40. This estimate is consistent with estimates of the accrual cost of imputation, which are higher than the cash costs.

<sup>31</sup> This is a significant caveat. If the corporation earns \$100 it pays \$19 tax. It can distribute \$81 to shareholders, who at the top rate pay \$45 tax for a total tax bill of \$64 (ignoring the Medicare Levy). If the corporation on the other hand retains its post-tax earnings the effective rate of tax stays at 19 per cent, so that the individual benefits from deferral of the personal income tax. He or she may ultimately be taxed on sale of shares; given the individual CGT 50 per cent discount, a gain could face a maximum nominal tax rate of about 40 per cent.

<sup>32</sup> Bergmann, M 'The Rise in Dividend Payments', *Reserve Bank Bulletin* (2016) March Quarter, p. 47 available from <https://www.rba.gov.au/publications/bulletin/2016/mar/pdf/bu-0316-6.pdf> (accessed 6/10/17) puts the average payout ratio over 2005-2015 at 67 per cent; market commentary is consistent with the higher figure in the text, see e.g. David Bassanese, *Dividends: What to Expect in 2016* (February 2016), <http://www.asx.com.au/education/investor-update-newsletter/201602-dividends-what-to-expect-in-2016.htm> (accessed 28/11/17).

income tax bias towards investment in housing and superannuation, making equity investments relatively less attractive.

The small open economy assumption that the marginal investor is foreign assumes that international corporate investment is perfectly mobile. This is unlikely to be true. Ainsworth suggests that the Treasury view that the Australian cost of capital is set by international markets 'stands as an extreme position' and that 'allowance should be made for the possibility that imputation might be priced partially, or even fully, in some situations'.<sup>33</sup> We also need to consider the worldwide corporate tax environment. If the corporate tax rate in other countries is close to that of Australia, then the marginal foreign investor may lower the required rate of return from investment around the world. That would support a 'public good' argument for putting a floor on the global corporate tax rate; Stiglitz has recently suggested that it should be a minimum of 20 per cent.<sup>34</sup>

### 2.3. *Modelling the removal of dividend imputation*

In spite of all the caveats above, it appears that we are currently in a global tax competitive environment where a binding floor on the corporate tax rate is not a feasible alternative and it is certainly not in Australia's control. Consequently, we consider in this paper the option of abolishing dividend imputation and using the revenue saved to fund a reduction in the corporate tax rate.

Abolishing imputation in order to fund a reduction in the corporate tax rate would appear to have two advantages: first, it lowers the required rate of return for foreign investors and second, it removes a subsidy for domestic investors (on the open economy view). We suggest that the abolition of imputation would be desirable in conjunction with any of our possible alternative corporate tax base reform options; it could also be a reform in itself.

Results from modelling suggest that ending imputation and replacing it with a lower corporate tax rate would be economically and fiscally beneficial. The modelling suggests that substantial additional revenue of \$11.6 billion each year could be raised for a relatively modest decline in savings incentives and consumer welfare (of \$1.5 billion).<sup>35</sup>

It seems likely that some of the revenue raised by removing imputation could be used to finance a dividend discount to help maintain financing neutrality. This would reduce the net revenue from the proposal and hence increase the revenue-neutral company tax rate that might be achieved, from 20 to around 25 per cent. This alternative is modelled by estimating the consumer welfare and fiscal cost of moving to "half franking", which suggests a gain in consumer welfare of \$4.1 billion and a fiscal gain of \$0.8 billion, while moving to a 25 per cent corporate tax rate.<sup>36</sup>

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<sup>33</sup> Ainsworth, A Partington, G and Warren, G 'Do Franking Credits Matter? Exploring the Financial Implications of Dividend Imputation' (2015) *CIFR Working Paper* No. 058/2015 / Project No. F004, p.3.

<sup>34</sup> Khadem, N, 'Nobel-prize winning economist Joseph Stiglitz on how to stop inequality and tax avoidance' *Sydney Morning Herald*, September 18, 2017, available from <http://www.smh.com.au/business/the-economy/nobelprize-winning-economist-joseph-stiglitz-on-how-to-stop-inequality-and-tax-avoidance-20170914-gyhnmh.html> (accessed 6.10.17).

<sup>35</sup> Murphy, above n 5, Table 6.1.

<sup>36</sup> Murphy, above n 5, Table 7.1.

A possible option is a 40 per cent discount on dividends to accompany the cessation of imputation. This is the discount proposed by the Henry Tax Review as a general regime for capital income and gains taxation (although that Review did not recommend abolishing imputation). If this discount on dividends at the shareholder level was combined with a 25 per cent company tax rate, then the effective tax rate on distributed (and taxed) corporate profit for those on a top marginal tax rate of 45 per cent would stay approximately the same, but for untaxed (foreign) corporate profit, this would reduce somewhat.

For those on lower marginal tax rates, or superannuation funds at the 15 per cent rate, a 40 per cent dividend discount instead of imputation would increase the effective tax rate on distributed profit that had been taxed in Australia, while reducing the effective tax rate for profit that had not been subject to company tax. For shareholders on a zero rate, the 25 per cent company tax rate would operate as a minimum tax on company profit. This brief analysis assumes a closed economy, that is, that the shareholders bear the company tax. As already noted, it seems likely that there would be some reduction in the dividend payout ratio, as dividends from taxed corporate profit would become less attractive for some individual and institutional shareholders; the discount offsets this to some extent. On an open economy assumption, replacing imputation with a dividend discount reduces the “subsidy” to domestic shareholders provided by the refundable franking credit.

### **3. Reforming the corporate tax base**

In the remainder of this article, we explore options for reform of the corporate tax base. We first consider the cash-flow tax (CFT) and other approaches that seek to exempt the normal return to capital and only tax economic rents: the allowance for equity (ACE) or allowance for corporate capital (ACC). These options are not designed to achieve a lower rate but rather a narrower but more efficient tax base by lowering the marginal effective tax rate on new investments. We then turn to options that broaden the corporate income tax base, hence allowing a lower rate. In particular the Comprehensive Business Income Tax (CBIT) denies a deduction for interest expense. This option taxes the normal rate of return, but (in our proposal) at a lower rate than the current system. We then outline several partial or hybrid approaches, including a hybrid ACC-CBIT system, limits on interest deductibility, or a dual income tax structure, that would take the system towards a broader income tax base but with a lower rate. These options would probably be accompanied by the abolition of dividend imputation, replaced by a discount at the shareholder level.

#### *3.1. The source-based corporate tax*

Our focus in presenting these options is on a source-based corporate tax which levies some tax on the return to capital (but at a lower rate than currently), while eliminating key distortions. We focus on the source-based corporate income tax for several reasons. First, this is Australia’s current system and any transition to a modified corporate tax base needs to take this into account.

Second, Australia is a net capital importer and resource-rich exporter. It is desirable to tax the return to capital at source in Australia. That is, Australia remains essentially a country where value is created and economic rents are earned through export of goods (primarily resource and agricultural goods) and services (primarily financial and education services). These characteristics indicate that Australia should

have a source-based tax system for corporations, rather than emphasising alternatives of a capital-exporting (residence) system or a destination-based (consumption) system.

Third, a source-based corporate income tax is consistent with the current international tax system, albeit that system is shifting in some respects to place more emphasis on destination or consumption elements such as sales.

Fourth, Australia has a relatively small, albeit rich, population in terms of consumption. However, this is not a reason to convert our corporate tax to a destination base. If we wish to tax consumption more heavily on a destination basis, we already have an effective value-added tax in place to do this: the Goods and Services Tax (GST). A simple policy lever available to government is to increase the rate and broaden the base of the GST. A tax mix shift away from the corporate tax funded by a higher GST has, indeed, been proposed in the academic and policy debate.<sup>37</sup> However, a simple tax mix switch involving a lower corporate tax and higher GST would reduce capital taxation in a way that may not be optimal for both efficiency and distributional reasons, as the aggregate taxation of capital in Australia is very light.<sup>38</sup>

### 3.2. *The corporate Cash Flow Tax (CFT)*

A cash flow tax (CFT), as Wilson suggests, 'is a particular form of an expenditure or consumption tax' that is in theory similar to the GST, except in the way in which it is collected.<sup>39</sup> The CFT base is sales minus purchases of real assets and services, ignoring financial assets and services. The GST base is sales minus purchase of real assets and services, except wages.<sup>40</sup> The Henry Tax Review considered a CFT as an alternative to the GST (its terms of reference prohibited it from canvassing an increase in the GST):

'A broad-based CFT at a single rate could replace many other taxes on consumption, while significantly reducing tax compliance costs, particularly for small business. The CFT could also provide a sustainable source of revenue to fund government services, while significantly reducing tax-induced biases to consumption choices ...The CFT is sometimes called a 'business activity tax' because it focuses on taxing entities, rather than outputs. For example, the United States Treasury ...has considered a direct subtraction business activity tax to replace business income taxes in the United States.'<sup>41</sup>

When considering corporate tax reform, we can also consider a corporate-level CFT.<sup>42</sup> The CFT is a subset of the broader business activity tax, as wages are exempt. Such a tax was called by the Henry Tax Review a *business level*

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<sup>37</sup> See e.g., KPMG 'Economic Analysis of the Impacts of Using GST to Reform Taxes' (September 2011). This report was prepared for CPA Australia.

<sup>38</sup> Murphy, above n 5.

<sup>39</sup> Wilson, P 'An analysis of a cash flow tax for small business' (2002) *NZ Treasury Working Paper 02/27*, December, p. 3.

<sup>40</sup> Wilson, *ibid.*, p. 5 Table 2.

<sup>41</sup> *AFTS Final Report*, above n 15, Part D1.

<sup>42</sup> We do not refer to modelling of the CFT in this paper, but discuss it as a benchmark against which the ACC and ACE options may be assessed.

*expenditure tax*.<sup>43</sup> The corporate-level CFT does not tax the 'normal' return to capital. The Henry Tax Review was attracted to the business level expenditure tax to remove tax biases and observed that this would reduce source-based taxes on capital:

'A business level expenditure tax would reduce source-based taxes on the normal return to investment in Australia, provide greater neutrality between debt and equity and reduce tax biases across different investments, improving the stability and productivity of domestic business and investment. It may also provide opportunities for wide-ranging simplification of the company income tax system. Such a system would provide a more effective mechanism for company and personal tax integration in a world of increased capital mobility.'<sup>44</sup>

A corporate CFT is, in theory, simpler than a corporate income tax because all base calculations are on a 'cash in, cash out' basis: the difference between payments and receipts is the tax base. It avoids the issue of how to treat expenditure on capital investments which is complex, uncertain and the subject of frequent and protracted disputes between taxpayers and the revenue, while capital gains are also challenging.<sup>45</sup> In the corporate CFT, interest expense, or the cost of financing investment, is not deductible. However, the corporate CFT is not as simple as it appears when financial services are taken into account. While financial flows (such as interest payments) would not be included in a simple CFT, they should be taxed through an equivalent tax on the domestic consumption of financial services.

The corporate CFT can be levied on a source or a destination basis (just as a VAT or GST could be similarly designed). A version of the corporate CFT (known as the Destination Base Cash Flow Tax) has been advocated by leading international tax experts, as a replacement for the US corporate income tax and, in part, the US personal income tax.<sup>46</sup> Auerbach et al observe: 'value added as measured by VAT is equal to the sum of economic rent and labour income. In a closed economy, a VAT which also gave relief for labour costs would be equivalent to an R-based cash flow tax' while in an open economy this result can be achieved with a DBCFT.<sup>47</sup> The

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<sup>43</sup> Henry Tax Review (2008), above n 15, *Australia's Future Tax System, Consultation Paper*, [https://taxreview.treasury.gov.au/content/ConsultationPaper.aspx?doc=html/publications/Papers/Consultation\\_Paper/appendix\\_e.htm](https://taxreview.treasury.gov.au/content/ConsultationPaper.aspx?doc=html/publications/Papers/Consultation_Paper/appendix_e.htm).

<sup>44</sup> *AFTS Final Report*, above n 15, Chapter 5: Investment and entity taxation.

<sup>45</sup> Edwards, C 'Replacing the scandal-plagued corporate income tax with a cash-flow tax' (2003) *Policy Analysis* No 484, August p12; Weisbach (cited in Edwards, p. 12 fn. 86) notes that capitalization is 'unbelievably complex' and 'extremely uncertain' for companies... Capitalization is a heavily litigated part of the tax code, with taxpayers winning about half of the cases against the IRS'.

<sup>46</sup> Auerbach, A Devereux, M Keen, M Vella, J 'Destination-Based Cash Flow Taxation' (2017) WP 17/01 January 2017 Oxford University Centre for Business Taxation; Auerbach, A (2010) 'Directions in tax and transfer theory', in Melbourne Institute *Australia's future tax and transfer policy conference*, for the Henry Tax Review.

<sup>47</sup> Auerbach, A. Devereux, M. and Simpson, H 'Taxing corporate income' in Mirrlees, J., Adam, S., Besley, T., Blundell, R., Bond, S., Chote, R., Gammie, M., Johnson, P., Myles G., and Poterba, J '[Dimensions of Tax Design](#)'(2010, Oxford University Press) 883, p. 890. In the NZ context, it was noted that the similarity between the CFT and the GST provided for administrative simplification. At the time the GST rate was 12.5 per cent, which meant that CFT liability could be calculated as 8 times the GST bill less gross wages paid. There would be some additional adjustments for exporters: Wilson, P (2002), above n 40, p. 11.



DBCFT has been claimed to have several highly attractive properties: it does not distort the scale and location of investment, assures neutral treatment of debt and equity as sources of finance, is robust against avoidance through inter-company transactions, and provides long term stability due to its incentive compatibility and its resistance to tax competition amongst states.

In June 2016, the Ways and Means Committee of the US House of Representatives proposed a version of a DBCFT.<sup>48</sup> This plan was taken up by some Republicans who sought to reduce the US corporate tax rate from 35 per cent to 20 per cent.<sup>49</sup> The destination base would tax sales in the US, but not overseas, in a similar manner to a destination based VAT. Purchases or investment abroad would not be deductible. Hence, the corporate level DBCFT would be based on where a corporation's products are used rather than where the corporation is located or where the goods are produced, eliminating incentives to shift profits abroad. However, President Trump and Congressional Republicans have since rejected the DBCFT option and produced a Framework which in its enacted form proposes expensing of much capital investment and partial denial of interest deductibility. As already observed, the revenue cost of shifting to a CFT is a significant challenge. In the US proposal, this would have been funded by a 'border adjustment' which would add a sort of tariff to businesses importing into the US under the destination basis.

Various other US Republican presidential hopefuls in the 2016 election were pushing for wide-ranging business tax reform that would be equivalent to a cash-flow form of GST or VAT.<sup>50</sup> The US has a history of proposals for economy-wide business and personal level expenditure taxes (although wages would continue to be taxed progressively at the individual level), for example the Hall-Rabushka flat tax proposal<sup>51</sup> or the Bradford X-tax.<sup>52</sup> The Bush Tax Reform Advisory Panel<sup>53</sup> of 2005 proposed the Growth and Investment Tax, a business level CFT under which capital expenditure and wages would be deductible, but not dividends and interest. The main reason for the attractiveness of all of these proposals in the US is likely to be the long-standing inability to enact a federal VAT or broad-based consumption tax.

Ultimately, we observe that no country has replaced a corporate income tax with a CFT. A large reason is revenue; a second reason is taxation of source-based rents. If Australia were to go down the path of a DBCFT, there would be a risk that this would not tax the resource sector sufficiently, as much of this sector's produce is

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<sup>48</sup> Ways and Means Committee of the US House of Representatives, 'A Better Way for Tax Reform' available from <https://waysandmeans.house.gov/taxreform/> (accessed 6.10.17).

<sup>49</sup> GOP Tax Plan, available from <https://taxfoundation.org/details-house-gop-tax-plan> (accessed 6.10.17).

<sup>50</sup> 'Not that they dare utter the 'V' word. A President Cruz would introduce a 16 per cent so-called 'business flat tax', while Paul would establish a 14.5 per cent 'business activity tax': <http://www.afr.com/opinion/columnists/why-do-united-states-republican-presidential-hopefuls-want-a-gst-20151115-gkzqlg> and <https://taxfoundation.org/details-house-gop-tax-plan> (accessed 6.10.17).

<sup>51</sup> Hall, R and Rabushka, A *The Flat Tax* (2007, Hoover Institution Press).

<sup>52</sup> Bradford, D, *Untangling the Income Tax* (1986) (Cambridge: Harvard University Press); Bradford, D, 'Blueprint for International Tax Reform' (2001) *Brooklyn J International Law* XXVI-4, 1449-1463.

<sup>53</sup> US President's Advisory panel on federal tax reform Simple, fair and pro-growth: proposals to fix America's tax system (2005).

consumed overseas, so an Australian DBCFT would need to be combined with a separate resource rent tax.<sup>54</sup> The CFT can also give rise to negative tax liabilities for growing firms, which would have to be refunded to maintain risk neutrality. Another reason for the failure to adopt a CFT at the corporate level is the use of income taxes as the dominant personal tax in many countries. Conceptually, a corporate-level CFT is consistent with a personal level expenditure tax rather than a personal income tax.

If the personal tax system were to move in the direction of expenditure taxation and away from income tax, a CFT at the corporate level becomes a more serious option. Similarly, if other countries moved in this direction, Australia may wish to consider it. In light of the growing international debate, the Henry Tax Review considered that other governments may move towards such systems and it could be in Australia's interest to join this trend.<sup>55</sup>

There may also be an advantage in allowing existing VATs to morph into comprehensive cash flow business taxes (with border adjustment) rather than introducing a new and complex CFT. Indeed, modelling suggests that a corporate tax rate cut to 25 per cent could be funded by an increase in the GST rate of less than 1 per cent.<sup>56</sup> Thus, as Auerbach et al note, 'increasing VAT and reducing corporate income tax and payroll taxes may be an attractive alternative to the full implementation of the DBCFT'.<sup>57</sup>

#### **4. Cash flow-equivalent taxes**

The corporate income tax can be modified to tax economic rents, making it equivalent to a CFT, through providing an allowance for corporate equity (ACE) or allowance for corporate capital (ACC). The ACE or ACC ensure that the corporate income tax would not apply to the 'normal' return to capital but only to super-normal profits, also known as economic rents. Another key reason to make such a change is to address the distortion in the current corporate income tax between debt and equity finance, in a cross-border context.

Classical corporate tax systems that 'double tax' dividends give rise to a bias in favour of debt financing because they permit interest deductibility. In the domestic (or closed economy) framework, Australia's dividend imputation system comes close to achieving financing neutrality between debt and equity for domestic investment. However, as observed above, cross-border, a bias remains towards debt. The ACE or ACC options essentially provide an additional tax deduction for equity investment and are both financing-neutral, at least in theory.

##### *4.1. Allowance for corporate equity - ACE*

The ACE starts with the normal definition of corporate income and subtracts an allowance – a percentage of book equity - which is designed to reflect either the risk-free or the 'normal' rate of return. In a paper for the Henry Tax Review, the ACE was

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<sup>54</sup> As acknowledged by Mike Devereux, TTPI conference, *What shall we do with company tax?* Australian National University, July 2017. An alternative is a resource rent tax to be applied to all companies: Boadway, R and Tremblay, J *Corporate tax reform: Issues and prospects for Canada* (2014) Mowat Centre #88, pp.45-46.

<sup>55</sup> *AFTS Final Report*, above n 15, p. 5.3.

<sup>56</sup> Specifically, a GST rate of 10.9 per cent on the current base is estimated: Murphy, above n 8, p. 29.

<sup>57</sup> Auerbach et al, above n 46, p.82; 84.

advocated by Sorensen and Johnson<sup>58</sup> in the context of a dual income tax (to which we return below). The Review supported an ACE as a possible long-term goal for business tax reform and suggested a variant of it for taxing resource rents.<sup>59</sup>

The ACE is a special case of a general economic 'rent' tax system initially suggested by Boadway and Bruce.<sup>60</sup> Sorensen and Johnson argue that the ACE is a means of taxing economic rents which avoids many of the problems associated with cash-flow taxes; 'the ACE is essentially equivalent to a source-based cash flow tax and therefore shares its neutrality properties'.<sup>61</sup> Boadway and Tremblay<sup>62</sup> recommended an ACE for Canada, arguing that the current corporate income tax was largely shifted to workers.

The ACE was also recommended by the Mirrlees Committee in the UK.<sup>63</sup> Mirrlees et al suggest that an ACE 'can be thought of in two ways: either as a counterpart to allowing the interest cost of debt finance to be tax deductible, or as a series of deferred tax allowances which compensate for the absence of the up-front 100 per cent allowance of equity-financed investment from the corporate tax base'.<sup>64</sup> The ACE works like a lump-sum tax, since it offsets the investment distortions caused by differences between tax depreciation and true economic depreciation. It implicitly allows a full adjustment for inflation so long as a nominal interest rate is applied to the unindexed equity base.<sup>65</sup> An important consideration for introducing an ACE is whether it applies only to new capital or equity investment; this avoids conferring a benefit on 'old' capital and improves the cost/benefit of the ACE approach, at least in the short to medium term.

Crossen explains, '[t]o be fully neutral, the ACE system requires the transformation of the PT into a personal consumption tax, which comprehensively exempts the normal return to capital'.<sup>66</sup> The Mirrlees Committee recommended that the ACE at the corporate level be accompanied by a rate of return allowance at the personal level. If in Australia dividend imputation was retained, the ACE could work basically

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<sup>58</sup> Sorensen and Johnson, above n 14.

<sup>59</sup> 'Under the resource rent tax, corporate cash flows would be tax-free until their value equalled the normal rate of return. All cash flows above that would be fully taxed. Like the Boadway-Bruce tax scheme, this is equivalent to a tax on returns': Boadway and Tremblay, above n 54, p.19.

<sup>60</sup> Boadway, R and Bruce 'A general proposition on the design of a neutral business tax' (1984) *Journal of Public Economics* 24, 231-239. We acknowledge, but leave to one side the issue of whether these are real rents or quasi-rents. See for example Reynolds, H and Neubig, T 'Distinguishing between 'normal' and 'excess' returns for tax policy' (2016) *OECD Taxation Working Papers No 28*, OECD.

<sup>61</sup> Sorensen and Johnson, above n 14, p. 211.

<sup>62</sup> Boadway and Tremblay, above n 54.

<sup>63</sup> Mirrlees, J., Adam, S., Besley, T., Blundell, R., Bond, S., Chote, R., Gammie, M., Johnson, P., Myles G., and Poterba, J *Tax by Design: the Mirrlees Review* (2011 Oxford: Oxford University Press).

<sup>64</sup> Mirrlees et al, above n 63, p. 421.

<sup>65</sup> Mirrlees et al, above n 63, p. 423.

<sup>66</sup> Crossen, S 'Tackling Spillovers by Taxing Corporate Income in the European Union at Source' (2015) No. 5790, CESifo Working Paper Series from CESifo Group Munich, p. 11.

as a withholding tax and the ultimate capital taxation system for domestic shareholders would have an income base.

De Mooij sees an ACE as the best solution to the tax bias inducing over-reliance on debt finance, arguing that the 'economic costs of debt bias are larger than previously thought, especially in the financial sector'.<sup>67</sup> He suggests further that the 'favourable treatment of debt at the corporate level is almost never offset by the personal income tax ... taxes on capital gains and dividends magnify debt bias'.<sup>68</sup> For domestic Australian equity, however, the imputation system mitigates this bias.

#### 4.2. *Issues with the ACE in practice*

The Henry Tax Review, in contemplating the replacement of corporate income tax with cash flow-equivalent systems such as the ACE or ACC, was concerned that there has been limited or no practical use of such taxes and so a reform in this direction could involve considerable risk and practical challenges. These include transition and issues in corporate and international taxation, for example, there may also be opportunities for tax arbitrage if Australia is one of only a few countries using such a system.

The efficiency or neutrality properties of the ACE depend on the ACE uplift rate being 'right'. The ACE can only approximate financing neutrality, as the allowance and carry-forward rate will necessarily be an approximation, for each firm, of its cost of equity capital. The risk-free or 'normal' return is generally proxied by a government bond rate; although a higher rate could possibly be used to reflect a firm's average costs of borrowing,<sup>69</sup> this could add considerable complexity.

Reynolds and Neubig argue that there is no clear definition of a 'normal' return and question whether a single uplift rate can adequately reflect the costs of equity capital for all corporations, because two crucial factors make the distinction between excess and normal returns challenging: 'heterogeneity and uncertainty'.<sup>70</sup> They also suggest that 'linking a normal return to the return on a government bond is unlikely to be appropriate given its irrelevance to the required rate of return investors demand'.<sup>71</sup> Highlighting changes in the Australian 10-year government bond rate to illustrate the point, Neubig and Cline show that indexing the normal rate of return to a government bond rate is not justified.<sup>72</sup> While the Australian bond rate increased from 6.6 to 10.9 percent in just six months during 1994, it fell to 5.2 percent between 1994 and 1998. The factors that determine the interest rate on a government bond are not closely tied to the factors that determine a firm's cost of borrowing<sup>73</sup> and these changes have no bearing on the hurdle rate of return for a long-term

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<sup>67</sup> de Mooij, R 'Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions' (2011) International Monetary Fund Fiscal Affairs Department <https://www.imf.org/external/pubs/ft/sdn/2011/sdn1111.pdf>, p. 489.

<sup>68</sup> De Mooij, above n 67, pp. 490, 491.

<sup>69</sup> Freebairn, J, above n 17.

<sup>70</sup> Reynolds and Neubig, above n 60, p. 2.

<sup>71</sup> Reynolds and Neubig, above n 60, p.4.

<sup>72</sup> Cline, Robert J. and Thomas S. Neubig. A Critique of the Economic Theory and Modelling Underlying the Australian Resource Super Profits Tax Proposal Ernst & Young LLP, June 2010.

<sup>73</sup> Cline and Neubig, above n 72, p. 26.

committed investment. As a result, Kayis-Kumar notes that 'it is questionable that an ACE equalises the tax treatment of debt and equity financing; rather, an ACE simply mitigates the debt bias'.<sup>74</sup>

In spite of these issues, the ACE is no longer in the theoretical realm. Belgium adopted an ACE some years ago. Croatia had one for several years; while Brazil, Italy, Turkey and Cyprus have variants.<sup>75</sup> However, few such experiments have survived. The main reason is that for a given revenue yield, the ACE requires a higher tax rate than a company income tax since normal returns are exempted. Because it essentially provides a new 'deduction' in the corporate income tax system, the ACE is vulnerable to tax planning. The distinction between old and new equity; the measure of the 'right' ACE uplift or allowance; and the provision of a new deduction for domestic equity investment all have potential to be 'gamed'. It has been suggested that:

'As underlined by an increasingly theoretical and empirical literature... for highly mobile multinational companies, the statutory and average tax rate on profits might even be more important for investment and location decisions than the effective marginal tax rate. This may help explain why a radical proposal like the ACE, despite its attractive neutrality properties, did not have much success in the real world.'<sup>76</sup>

Thus, it is suggested that the abolition, or the reduction in the value of allowances, for various ACE-variants 'was in line with the dominant trend of reducing headline corporate income tax rates in the context of "tax-rate cut cum base broadening".'<sup>77</sup>

Estimates of the revenue loss from an ACE, due to the smaller base, range from 15 per cent to over 30 per cent.<sup>78</sup> These are big revenue losses, although there might be some offset from higher economic growth. Cooper suggests that a revenue-neutral tax rate under an Australian ACE would be 37 per cent.<sup>79</sup> Murphy estimates that 59 per cent of corporate tax is collected on normal returns to capital and hence suggests that a rent tax would narrow the tax base by more than Cooper's estimate.<sup>80</sup>

In simulations for EU countries, de Mooij and Devereux find the ACE was welfare-improving if the reduction in corporate tax receipts was made up by increased consumption taxation; if, however, the corporate tax rate was increased to cover the

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<sup>74</sup> Kayis-Kumar, A 'Thin capitalisation rules: A second-best solution to the cross-border debt bias?' MPRA Paper No 72013, p. 19, also in (2015) *Australian Tax Forum* Vol. 2, No. 30 (2015) 299-355.

<sup>75</sup> Cooper, G 'Theories of modern tax reformers' (2011) *The Tax Specialist* (August), p. 10; and see Reynolds and Neubig, above n 72, Table 3.

<sup>76</sup> Bordignon, M, Giannini S and Panteghini P 'Reforming business taxation: lessons from Italy' *SIEP Working Paper* (2000), p. 13.

<sup>77</sup> Kayis-Kumar, above n 74, p. 20.

<sup>78</sup> Kayis-Kumar, above n 74, p. 26.

<sup>79</sup> Cooper, G 'Implementing an Allowance for Corporate Equity' (2012) *Australian Tax Forum* Vol. 27(2), 241-72.

<sup>80</sup> Murphy, above n 5, and update.

cost, welfare was reduced.<sup>81</sup> These authors note the conclusions of Bond that base narrowing under ACE 'renders it unattractive for open economies since higher corporate tax rates induce a strong erosion of the corporate tax base due to profit shifting.'<sup>82</sup> They observe that as a result, Bond advocates the CBIT (to which we turn in the next Part).

Ultimately, we suggest that the ACE may be an unstable system because of these various weaknesses. At any given ACE rate of allowance, it would be possible to move to a conventional income base and get the same revenue at a lower headline rate, which is likely to be a tempting option for governments concerned about base erosion and international tax rate competition. This seems to have been the story of ACEs in practice.<sup>83</sup> Concerns about the ACE benefiting multinational companies have resulted in a 'plethora of legislative amendments'<sup>84</sup> to limit the risk. In practice, ACE uplift rates (e.g. in Italy and Belgium) have departed from long term bond rates and have in fact become tools for policy manipulation.

In spite of these concerns, the ACE is, nonetheless, an effective means of taxing 'super profits' in the corporate sector, especially in the financial sector. This could make it attractive as an element of a corporate tax system that applies to 'super profits' of banks or resource companies, from a policy and political perspective. Australia's four big banks are the most profitable in the developed world, with consistently high returns and yearly profits:

'Analysis by the RBA shows that, in terms of return on equity (ROE), the big four banks averaged about 15 per cent by the end of 2015, ahead of Canada's banks (14 per cent) and more profitable than banks in the US and Europe, whose ROE came in at less than 10 per cent.'<sup>85</sup>

Murphy<sup>86</sup> has suggested that one means of funding a corporate tax cut to 25 per cent might be a tax on banking rents.

#### 4.3. Allowance for corporate capital (ACC)

The ACC was proposed by Boadway and Bruce.<sup>87</sup> The ACC is similar to the ACE, however instead of a separate deduction for debt and equity, firms are instead allowed to deduct an imputed rate of return (a notional risk-free return on capital) on their entire book asset base (debt plus equity), regardless how this is financed.

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<sup>81</sup> de Mooij, R and Devereux, M 'Alternative systems of business tax in Europe An applied analysis of ACE and CBIT reforms' (2009) *Taxation Paper No. 17, European Commission*, available from [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/docs/body/acecbt\\_study.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/acecbt_study.pdf), p.15.

<sup>82</sup> De Mooij and Devereux, above n 81, p. 90, citing Bond, S 'Levelling Up or Levelling Down? Some Reflections on the ACE and CBIT Proposals, and the Future of the Corporate Tax Base', in S. Cnossen (ed.), *Taxing Capital Income in the European Union* (2000 Oxford University Press: Oxford).

<sup>83</sup> See the discussion of the Belgian ACE in Reynolds and Neubig, above n 60, p. 19.

<sup>84</sup> Kayis-Kumar, above n 74, p. 29.

<sup>85</sup> Courtenay, A 'Aussie Banks the World's Most Profitable' (29 March 2016), citing Bank for International Settlements; Reserve Bank of Australia, <http://finsia.com/news/news-article/2016/03/29/aussie-banks-the-world-s-most-profitable>.

<sup>86</sup> Murphy, above n 5.

<sup>87</sup> Boadway, R and Bruce, above n 60.



Actual interest is not deductible. The ACC is economically equivalent to a “real” or R-base CFT. It also shares the drawbacks of that system, in that an ACC hurts heavily indebted firms and largely exempts the financial sector from tax.<sup>88</sup> If we desire to tax the financial sector, this is an issue that needs to be addressed separately.

Boadway and Tremblay consider that the ACC, which they call a capital account allowance, is the preferred form of cash-flow equivalent tax since it is more flexible and easier to administer.<sup>89</sup> However they ultimately prefer an ACE since it allows an easier transition to the new system. On the other hand, Kayis-Kumar suggests ‘A key advantage of the ACC is that it entirely eliminates the debt bias, unlike the ACE which only partially achieves funding neutrality’.<sup>90</sup> She notes that an ACC has also been compared to a combined ACE-CBIT.<sup>91</sup> The ACC has some similarities to the Dual Business Enterprise Income Tax (the Dual BEIT) proposed by US tax academic Ed Kleinbard.<sup>92</sup> However, in Kleinbard’s proposal the imputed return deducted by firms would be taxed to individuals using an identical imputation rate, so the aggregate tax base becomes an income base.

#### 4.4. *Modelling the ACE/ACC*

The economic theory and modelling suggests that the ACE/ACC are in economic terms superior to the corporate income tax as they do not create disincentives for marginal investment and only tax economic rents. However, the ACE and ACC narrow the base, as ‘super-normal’ profits or economic rents make up a only a portion of total company income that is currently subject to the corporate tax.

We earlier noted estimates that the normal return represents between 30 and 60 per cent of the corporate return.<sup>93</sup> The ACE and ACC are therefore not revenue-neutral in the absence of other changes such as the abolition of dividend imputation or an increase in the GST rate.

The modelling is of the ACC rather than the ACE on the assumption that the two are essentially equivalent (but recall that the ACE can be better applied to the financial sector). If a 30 per cent corporate tax rate and the imputation credit system remains, the modelling indicates that shifting to an ACC or rent tax base would produce a very substantial gain for consumer welfare of \$18.1 billion, but at a high fiscal cost of \$26.1 billion per year. If the rent tax is applied and franking is removed, the consumer welfare gain is lower but still significant at \$16.6 billion, at a fiscal cost of \$14.9 billion.<sup>94</sup> This reflects the very high MEB involved in taxing normal returns.

The rent tax could be applied in the Australian context in conjunction with the general corporate income tax at a lower rate. For example, we could reduce the corporate

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<sup>88</sup> Sorensen and Johnson, above n 15, p. 212.

<sup>89</sup> Boadway and Tremblay, above n 54, p. 54.

<sup>90</sup> Kayis-Kumar, above n 74, p. 36.

<sup>91</sup> Kayis-Kumar, above n 75, p. 37.

<sup>92</sup> Kleinbard, E ‘Reimagining capital income taxation’ (2015) No 1524, [Working Papers](#) from [Oxford University Centre for Business Taxation](#).

<sup>93</sup> Freebairn, J, above n 17, p.359 discusses various US and Australian estimates in this range; the estimate by Murphy, above n 8 is consistent with the literature.

<sup>94</sup> Murphy, above n 5, Table 6.1.

income tax rate to 25 per cent and levy a supplementary ACE as a means of taxing banks likely to enjoy super profits. Considering the option of a rent tax specifically on the financial services sector (set at 8 per cent), the modelling indicates that this could fund a corporate tax rate cut to 25 per cent at a welfare gain of \$5.4 billion.<sup>95</sup>

The ACC and ACE seek to achieve debt-equity financing neutrality at the corporate level by providing an actual or imputed allowance for equity or capital investment. These policy proposals however ignore a key issue in contemporary international tax debates, concerning the base erosion of source-based corporate taxes through the use of excessive interest deductions.

## 5. Comprehensive business income tax (CBIT)

An approach that equalises the treatment of debt and equity at the corporate level is the comprehensive business income tax (CBIT). The CBIT was originally proposed by the US Treasury.<sup>96</sup> The CBIT aims to fully integrate the corporate and personal income tax by disallowing the deduction for interest costs and exempting dividend and interest income and capital gains at the personal level.

The goal of the original CBIT proposal was to achieve a uniform tax rate on all corporate source income at a rate around the top marginal rate of income tax on capital income, eliminating double taxation. This would also require reform at the personal level and it was particularly attractive because of the classical US corporate-shareholder tax system, in which interest is deductible but dividends are not (albeit taxed at a discount). Proposals to limit or deny the corporate interest deduction to eliminate this non-neutrality and tax corporate income only once, have a long history in US tax policy discourse.<sup>97</sup>

In Australia, the Henry Tax Review considered the interest deduction and suggested:

‘Two broad approaches to improving international competitiveness through tax measures are to reduce statutory tax rates or to narrow the tax base. The first approach would involve retaining a broad income tax base and lowering the company tax rate. More radically, it could involve limiting interest deductions either fully, as under the ‘comprehensive business income tax’ (CBIT) proposal by the United States Treasury in 1992, or in part, as done recently in Germany. The second approach would involve narrowing the company tax base in preference to reducing the existing company tax rate.’<sup>98</sup>

While the Henry Tax Review tended towards both a lower rate and an ACE, in the current era of BEPS abolishing interest deductibility is increasingly attractive. The CBIT has been recently suggested in both US and EU contexts.<sup>99</sup> This base-

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<sup>95</sup> Murphy, above n 5, Table 7.1.

<sup>96</sup> US Treasury *Integration of the individual and corporate tax systems: taxing business income once* (January 1992: US Government Printer), p. 40.

<sup>97</sup> See, e.g., Warren, A ‘The corporate interest deduction: a policy evaluation’ (1974) *Yale Law Journal* 1585-1619, Schlunk, H J ‘The Zen of corporate tax structure neutrality’ (2000) *Michigan Law Review* 99:2 November 410-451; Pozen, R and Goodman, I ‘Capping the deductibility of corporate interest expense’ (2012) *Tax Notes* December 10.

<sup>98</sup> Henry Tax Review (2009) *Consultation Paper*, above n 15, p. 134.

<sup>99</sup> Swedish Corporate Tax Reform Committee (2014), *Neutral bolagsskatt – för ökad effektivitet och stabilitet* (Neutral corporation tax - for increased efficiency and stability). SOU 2014:40, Stockholm

broadening measure could finance a reduction in the headline rate of corporation tax while removing the tax-induced distortion between debt and equity, and can also counter international tax planning, which as discussed in the next section heavily utilises the interest deduction.

There are various estimates of the revenue impact of denying an interest deduction. Schlunk<sup>100</sup> suggests that the US 35 per cent rate could fall to 16 per cent if interest was denied. Sullivan argues that the interest deduction is necessary in an income tax world:

‘But in a world with corporate taxes, all this changes. The corporate tax is an arbitrary tax with no solid economic justification. It puts an extra layer of tax on capital income, but only on capital income accruing to specific corporations. And of that corporate capital income, only the income funded with equity is subject to the tax. Corporate debt is favoured over corporate equity. So for the corporate tax, the deduction for interest has the opposite effect it has for the individual income tax. It reduces neutrality.’<sup>101</sup>

The resulting distortions are large and pervasive throughout the corporate sector. Corporate investment funded primarily with debt can have an effective tax rate close to zero, while corporate investment funded primarily with equity is effectively taxed close to the statutory rate. The combination of debt finance and other tax deductions such as excessive tax depreciation can easily result in negative effective corporate tax rates on investment. In the extreme, 100 percent debt financing and investment expensing result in an effective tax rate equal to minus 35 percent.

### 5.1. *Issues with design of a CBIT*

There are a number of issues regarding the design of CBIT. Even more than the ACE/ACC, it has never been implemented by any country although as discussed in the next section, there are many ad hoc rules to limit interest deductibility around the world. Nonetheless, because the CBIT is an income tax, it is fundamentally similar to our current tax base and so the current corporate tax can be modified to phase in a CBIT over time.

The first issue is identifying the firms to which the CBIT applies, as in principle, the CBIT need not be limited to corporate entities. Indeed, a broader CBIT may be even more effective. Avi-Yonah suggests that:

‘Under CBIT, all business entities, whether incorporated or not, are subject to a business level tax at the same rate. Dividends and interest are both not

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2014, cited in Sorensen, P B ‘Taxation and the Optimal Constraint on Corporate Debt Finance: Why a Comprehensive Business Income Tax is Suboptimal’ (2017) *International Tax and Public Finance* 24:731-753, DOI 10.1007/s10797-016-9432-1; Hasen, D, ‘CBIT 2.0: A Proposal to Address US Business Taxation’ (September 2, 2013). *Tax Notes*, Vol. 140, August 26, 2013. Available at SSRN: <http://ssrn.com/abstract=2319326>;

<sup>100</sup> Schlunk above n 97, p. 450.

<sup>101</sup> Sullivan, M ‘Treat Corporate Interest Deductions like Any Tax Expenditure’ *TaxAnalysts* <http://www.taxanalysts.com/www/features.nsf/Articles/0BB1F6D13297CC6285257A5200511B3F?OpenDocument> (2012) accessed 10.10.17.

deductible, but are exempt at the recipient level. This solution takes care of all of the three biases directly.<sup>102</sup>

The biases referred to are (1) against operating in a corporate structure; (2) against dividend distributions (this is in the US context, and does not apply so much in an imputation system like Australia's); and (3) against equity in favour of debt because interest is deductible and dividends are not (but see the caveat above). The CBIT may however make a distinction between CBIT entities and non CBIT entities:

'Most firms, including non-corporate ones, will be CBIT entities; only very small firms will not be. The CBIT entities are not allowed interest deductibility. To avoid double taxation, interest that CBIT firms receive from other CBIT entities is exempt or credited. However interest that firms (or banks) receive from non-CBIT entities is subject to tax, including interest from households and government bonds. Interest received from abroad will also be subject to tax.'<sup>103</sup>

The CBIT solves some corporate income tax distortions but others remain, relating to 'capital expenditure, inflation-caused distortions and a bias against savings and investment'.<sup>104</sup> As it is an income tax, depreciation for capital assets remains; this is a source of complexity but, on the other hand, also an additional policy lever, as the CBIT can be combined with accelerated depreciation or an investment allowance for capital assets.

The CBIT would, of course, result in heavier taxation of interest income flowing to foreign entities, since this would essentially be taxed at the (new) corporate tax rate. Franked dividends which have borne the 30 per cent tax rate are currently exempt from withholding tax, so their tax rate would move down in line with the general reduction in the corporate tax rate. If we applied the CBIT in Australia, the effective tax rate on foreign borrowings rises to the corporate tax rate. There may need to be some transitional relief and some re-negotiation of international tax agreements.

The CBIT eliminates base erosion opportunities that utilise interest deductibility in the international context. However, the CBIT may not solve all cross-border tax planning, as there may be opportunities for multinational enterprises to convert cross-border flows to royalties, fees and services that would be deductible and are to some extent fungible with debt-equity flows.<sup>105</sup>

There are two further important hurdles to be overcome if interest deductibility is to be abolished. The first is that abolishing interest deductibility outright would discriminate against financial corporations; so, a key challenge of the CBIT is how to deal with the financial sector. The second hurdle concerns transition to a CBIT. If it was introduced with immediate effect, marginal firms with large debts could go broke overnight. It is usually suggested that the CBIT would be phased in over time. For

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<sup>102</sup> Avi-Yonah, R 'Corporate tax integration and debt/equity distinction: the case for dividend deduction' (2010) *Columbia law School tax policy colloquium*, p. 3.

<sup>103</sup> de Mooij, above n 67, p. 502.

<sup>104</sup> Edwards, C (2003) 'Replacing the scandal-plagued corporate income tax with a cash-flow tax' *Policy Analysis* No 484, August, p. 32.

<sup>105</sup> Kayis-Kumar, A *Taxing multinationals: Preventing tax base erosion through the reform of cross-border intercompany deductions* (2017), unpublished PhD thesis.

example, Pozen and Goodman suggest a ten year phase of the interest caps and the lower corporate tax rate.

The CBIT effectively exempts traditional banking from taxation. Net interest costs would no longer be deductible; however, the financial sector in general has negative net interest costs and under the CBIT, banks are not taxed on interest income received on outstanding loans to CBIT firms. The margin between the lending rate and the borrowing rate is exactly the income earned by primary banking activities. Schlunk's proposal, above, would include financial corporations. Another possible response is to have a partial deduction for interest; for example, Pozen and Goodman suggest allowing non-financial firms to deduct only 65 per cent of gross interest and financial firms, 79 per cent. This pragmatic solution would have had, at least, the benefit of financing a US corporate tax rate cut from 35 to 25 per cent. One goal of such a proposal is to making financial institutions less leveraged, a common theme in the US literature.

Another option may be to tax the net interest income of all firms, while not allowing a deduction for firms with a net interest expense. This would tax the financial sector but there would be a risk of avoidance by financial institutions merging with non-financial institutions so that the latter could claim its interest expense against the net interest income of the former. Anti-avoidance provisions would be needed to prevent this.

In contrast to banks, non-financial businesses will pay tax on the full borrowing rate, including the bank's margin. The lower tax burden on banks will likely reduce the interest margin of banks. If banks earn rents or 'super-profits' then the government may forgo revenue from failing to taxing these rents.<sup>106</sup> If it is the case that, in an open economy the interest rate is determined by world markets, then only domestic banks will pay no tax on the interest received from CBIT firms. In this context, domestic banks could charge more competitive rates to domestic CBIT firms than foreign banks who are taxed in their home country on the interest received. Introducing a CBIT in a single country could, therefore, distort international banking.<sup>107</sup> In relation to financial institutions, the US Treasury was of the view that CBIT:

'would exempt from tax much of the income received by financial institutions because it is received in the form of dividends and interest from CBIT entities... [However] this general rule would operate to disallow a significant proportion of their operating expenses if deductions for such expenses were not allowed. This effect is likely to be less significant for direct lenders such as banks and finance companies because they would no doubt begin to charge fees (rather than interest) to cover the costs of making a loan... a CBIT borrower could deduct fees but not interest.'<sup>108</sup>

Ultimately, a CBIT may lead to a lot of adjustments in the market place, and the ultimate impact on financial corporations would depend on the degree of competitiveness in the industry.

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<sup>106</sup> de Mooij, above n 67, p. 503.

<sup>107</sup> de Mooij, above n 67, p. 15.

<sup>108</sup> US Treasury, above n 95, p. 58.

The CBIT can be modified into a flat rate tax on capital income, along the lines of the so-called dual income tax (which we discuss below). Because of its broader tax, the CBIT allows a lower tax rate for given revenue and the tax base becomes less vulnerable to BEPS. The CBIT raises the cost of debt-financed capital but reduces the cost of equity capital (through the lower corporate tax rate). This is a trade-off that may be worthwhile from an efficiency and revenue perspective.

## 5.2. *Modelling the CBIT*

Various researchers have used different approaches to estimating a revenue-neutral CBIT. De Mooij and Devereux found that a CBIT would raise corporate tax revenue by 76 per cent.<sup>109</sup> Bond suggests that the benefit from a lower tax rate under CBIT is likely to outweigh the costs induced by the higher cost of capital.<sup>110</sup> De Mooij and Devereux model this option for European countries and find that the welfare costs of a higher cost of capital and the welfare gain from inward profit shifting (due to the lower corporate tax rate) produce a marginal net GDP gain of 0.74 per cent for an average EU country.<sup>111</sup> On average in the EU, they suggested that introducing a CBIT can fund a corporate tax rate reduction of 12.3 percentage points. They find a welfare loss from the higher net cost of capital and a welfare gain due to inward profit shifting; these roughly cancelled but for most countries there were net gains. By contrast, there were net welfare losses under an ACE if the corporate tax rate was raised to recover lost revenue.

Brekke et al consider that, relative to the CBIT, the ACE has a narrower base but the CBIT distorts marginal investment decision compared to the ACE.<sup>112</sup> They conclude that the welfare comparison between the two taxes was ambiguous and depended on assumptions about production technology, entry and the level of the corporate tax rate. Similarly, de Mooij et al considered that if corporate tax rates for the EU are lowered, to make the CBIT revenue neutral, this will have a positive welfare effect due to stronger investment incentives and inward profit shifting. They suggest that compared to the ACE, the CBIT:

‘Has less appeal since it exacerbates marginal investment distortions. The outcomes from numerous CGE [computable general equilibrium] models confirm this... This view ignores, however, international distortions induced by high statutory corporate tax rates ... [these] distortions render low effective marginal tax rates less important and low statutory rate more important for individual countries’.<sup>113</sup>

Ultimately, in their modelling and taking the rate and base into account, the CBIT was superior: the ACE was only superior if the tax was co-ordinated across the EU. Radulescu and Stimmelmayer suggest that the best output effects can be gained with a corporation tax reform incorporating the CBIT and a provision for immediate write-off of capital investment (expensing, or 100 per cent depreciation): this combination

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<sup>109</sup> De Mooij and Devereux, above n 81.

<sup>110</sup> Bond, S (2000), above n 82.

<sup>111</sup> De Mooij R and Devereux M (2008), above n 81, pp. 70, 76.

<sup>112</sup> Brekke, K, Pires, A, Schindler, D, and Schjelderup, G ‘Capital taxation and imperfect competition: ACE vs CBIT’ (2015) IEB 2015/27, p. 22.

<sup>113</sup> De Mooij and Devereux, above n 81, p. 99.



was found to be economically superior to the ACE.<sup>114</sup> This approach is very similar to the cash flow tax.

These European modelling results are consistent with the more recent US studies and reform proposals which have found good output effects from denying interest deductibility and allowing immediate write-off (expensing) of investments.<sup>115</sup> It would be possible to combine the CBIT with immediate write-off of capital investment;<sup>116</sup> however, fiscal constraints would again be an issue, as the capital expensing would need to be financed by a higher corporate tax rate or other taxes. The new US system combines expensing (for a limited period) with limitations on interest deductibility.

Modelling for Australia shows that converting the current income tax to a CBIT, while leaving the rate unchanged at 30 per cent and the imputation system in place, would raise revenue of \$6.1 billion per year; however, there is a net welfare loss of \$3.3 billion per year because the normal return to capital is taxed.<sup>117</sup> The MEB of the CBIT at the 30 per cent rate, with franking, is 53 per cent; without franking, it is 27 per cent. These both compare favourably to the MEB of the current corporate tax of 104 per cent. In modelling the CBIT, the model assumes that the net interest margin of financial corporations would be taxable in the CBIT.

If we move to a corporate tax rate of 25 per cent, the modelling suggests that the welfare loss is converted to a welfare gain at this lower rate. The CBIT would raise sufficient revenue to fund a rate cut to 25 per cent, producing a budget gain of \$0.7 billion per year, and an increase in consumer welfare of \$2.6 billion.<sup>118</sup>

The CBIT is less beneficial for consumer welfare than the ACC, or rent tax (about half as much), but these taxes show a large net cost. Both the ACC and CBIT achieve debt-equity financing neutrality. It should be noted that the Australian modelling does not include the welfare benefit of eliminating the debt-equity non-neutrality, which was recently estimated by Sorensen (in a European context) at about 5 per cent of corporate tax revenue.<sup>119</sup>

The CBIT reform option would ideally be combined with removal of the imputation system and its replacement with a dividend and interest discount at the personal level, which is proxied in the model by “half franking” and would produce a further revenue and consumer welfare gain. The CBIT could be combined with this option, which would increase its attractiveness from an economic perspective.

In summary, the CBIT seems at first glance an unlikely reform in the Australian context, given our imputation system, strong reliance on interest deductibility to support foreign investment and history of a progressive income tax rate structure.<sup>120</sup>

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<sup>114</sup> Radulescu and Stimmelmayer ‘ACE vs CBIT: which is better for investment and welfare? (2006) *CESifo Working Paper* No 1850 November, p. 3.

<sup>115</sup> GOP (2016), above n. 49, p. 34 and references cited therein.

<sup>116</sup> As suggested by *Stagnation Nation?* above n 17.

<sup>117</sup> Murphy, above n 5, Table 6.1.

<sup>118</sup> Murphy, above n 5, Table 7.1.

<sup>119</sup> Sorensen, above n 99.

<sup>120</sup> Cooper, above n 75, p. 12.

However, a broadening of the corporate tax base using the CBIT can fund a reduction in the corporate tax rate while raising revenue and preventing profit shifting which is becoming increasingly recognised as a serious problem. Therefore, we suggest that a modification of the corporate tax to phase in a CBIT is a serious option for Australia. The financial sector would need to be included in the CBIT base with adjustments, or taxed separately, on the net interest margin. A hybrid policy that combines a CBIT with a rent tax on banks could be appropriate.

If a CBIT were enacted, dividend and interest income probably should continue to be assessable at the individual level, at a discount. Dividend imputation would need to be abolished since with the CBIT options it is not needed to achieve financing neutrality. If we introduced a CBIT (and removed imputation), interest would need to receive the same discount as dividends in the personal income tax, to ensure neutrality. There are good reasons to give a discount for interest income to individual investors in any event, mainly because of the over-taxation of interest income under inflation. This is a very salient problem at a time when the inflation component now comprises over two thirds the total return to savers using bank accounts. Consistent with the Henry Report, this discount need not be confined to corporate source interest.

## **6. BEPS and the trend towards limits on interest deductibility**

While either an ACC or a CBIT are possible approaches for corporate tax base reform, it may be more likely that governments including Australia will enact increasing limits on cross-border interest deductibility together with other anti-avoidance rules. Such changes to the corporate tax base could bring the corporate tax closer to financing neutrality and tighten some loopholes. However, they are unlikely to raise enough revenue to finance the corporate tax rate cut, so governments would need to finance a lower corporate tax rate in other ways, for example through bracket creep or a GST increase.

### *6.1. Cross-border tax planning and interest deductibility*

Highly leveraged intra-group financing by multinationals generating interest deductions in 'high tax' countries (for example through related party debt contracts and finance corporations inside the group) is widespread and effective in reducing the tax burden of many multinational corporations in Australia and elsewhere. This has contributed to base erosion where there is substantial foreign ownership.<sup>121</sup>

In response, countries have established many anti-base erosion measures, most importantly thin capitalisation rules that cap the interest deduction by a ratio or ad hoc limit, to address cross-border tax avoidance strategies. There are recent signs that thin-cap rules are being got around by revaluing assets. These rules are almost certainly 'second-best' solutions, as 'innovations to financial instruments have challenged the traditional financial and legal distinctions between debt and equity':

'thin capitalisation rules considerably complicate corporate tax systems, reduce investment, are usually ad-hoc and not well targeted, and are often

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<sup>121</sup> *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62 (Full Court of the Federal Court of Australia); ATO Practical Compliance Guideline PCG2017/D4, dealing with the compliance approach to taxation issues associated with cross-border related party financing arrangements.

avoided by MNEs that can exploit hybrid instruments and international differences in definitions of debt and equity... some leading commentators suggest that rather than mitigating the debt bias, thin capitalisation rules simply encourage levels of debt at the specified threshold debt-equity ratios.<sup>122</sup>

As De Mooij states, the fungibility of interest and dividends has led to tax laws becoming very complex:

‘This is especially due to the presence of hybrid financial instruments that have some characteristics of debt but others of equity ... Intracompany debt within multinationals is even more difficult to define ... it is difficult to determine the appropriate interest rate – especially the risk premium – for intracompany debt.’<sup>123</sup>

Similarly, Warren observes that debt and equity both serve the same economic function of providing financial capital:

‘This identity of the function of debt and capital instruments forms the core of the case for equivalent treatment of interest and dividend payments...disparate tax treatments results in an arbitrary differentiation of corporate income...corporations and their investors have a powerful incentive to characterize an investment contract as debt in order to avoid taxation of corporate receipts at both the corporation and investor levels. The resultant tidal wave of litigation has produced only confusion and a torrent of contradictory commentary.’<sup>124</sup>

Government concern about international tax planning using interest deductions is indicated by the attention paid to debt in the BEPS Action Plan, including proposals to limit thin capitalisation in Action 4.<sup>125</sup> However, it is not easy to establish consistent solutions to these challenges and in the BEPS project, governments could not agree on how best to strengthen these rules.<sup>126</sup> Countries are therefore enacting their own rules. Interest deductibility is limited in Germany and Denmark (as a percentage of earnings before income tax) and now the US, and limitations are being considered in other European countries.<sup>127</sup> Where there is no inclusion of a dividend or payment between related parties in the EU, interest deductibility may be denied.

A recent study find that a range of ‘ad hoc’ options involving reduced or capped interest deductions and other reforms, have been carried out in the EU between 1998 to 2015; these have achieved a level of corporate tax base broadening

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<sup>122</sup> Kayis-Kumar, above n 74.

<sup>123</sup> De Mooij, above n 84, p. 496. Often limits allow carryover to later years.

<sup>124</sup> Warren above n 97, p. 1605.

<sup>125</sup> OECD BEPS Project, Action 4 Report, available from [www.oecd.org/beps](http://www.oecd.org/beps) (accessed 6.10.17). Also relevant are aspects of Action 2 on hybrid instruments (many of which are debt-equity hybrids established to obtain a ‘double dip’); and the application of transfer pricing rules to related party debt.

<sup>126</sup> Burnett, C ‘Intra-group debt at the crossroads: Stand-alone versus Worldwide Approach’ (2014) *World Tax Journal* 61(1), 40-76; ‘Interest Deductions and Multinational Enterprises: Goldilocks and the Brave New World’ (2015) *Bulletin of International Taxation* Vol 69 No. 6/7, 326-333.

<sup>127</sup> Cooper, above n 75, p. 12.

between 1998 and 2015 that appears to have funded corporate rate cuts.<sup>128</sup> It has been suggested that thin capitalisation rules may be more efficient than fully eliminating interest deductibility (by moving to the CBIT).<sup>129</sup>

It is worth observing that interest deductions are also excessive because most income taxes are not adjusted for inflation; if interest costs were indexed the deductions would fall by a half to a third. Gravelle canvasses the approach of taking the inflation premium out of deductible interest and suggests that this could finance a reduction in the US corporate tax rate of up to 2.5 percentage points.<sup>130</sup>

## 6.2. *Limits on interest deductibility in Australia*

For many years, Australia had a generous rule for cross-border interest deductibility, with a thin capitalisation rule permitting a 1:3 debt equity ratio (or 1:6 for financial institutions and banks). This was widely understood to be aimed at reducing the cost of capital for Australian enterprises seeking foreign investment. Other provisions, including our very low interest withholding tax rate also supported this aim. Debt interest from Australia now faces a withholding tax rate of between zero and 10 per cent, depending on the country and bilateral tax treaty, with an average rate of 3.5 per cent.<sup>131</sup>

The thin capitalisation ratio was reduced to 1.5:1 under the previous Labor government (a reform that the current government did not seek to reverse). However, an attempt by the Labor party to tighten a rule permitting the characterisation of hybrid interests as debt was not enacted. There is evidence that the alternative asset test in the thin capitalisation ratio is being gamed with asset revaluations. In 2016, a parliamentary inquiry addressed the corporate interest deduction which was estimated by the Chair as being worth \$50 billion in 2012-13.<sup>132</sup> The Treasury noted that the gross (not net) corporate interest deduction in 2012-13 was \$164 billion, which would have reduced company tax by \$49 billion.<sup>133</sup> In spite of this large fiscal cost, Treasury did not support abolishing or, even, limiting further the interest deduction:

‘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.

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<sup>128</sup> R Bräutigam, C Spengel, and K Stutzenberger ‘The Development of Corporate Tax Structures in the European Union from 1998 to 2015 – Qualitative and Quantitative Analysis’ (2017) ZEW Discussion Paper No. 17-034.

<sup>129</sup> Sorensen, above n 99.

<sup>130</sup> Gravelle, J ‘Corporate tax reform: issues for Congress’ *CRS Report for Congress* (2014) p. 44.

<sup>131</sup> Henry Tax Review, *AFTS Consultation Paper*, above n 15 (2009).

<sup>132</sup> Australian Parliament, House of Representatives Standing Committee on Economics, *Inquiry into Tax Deductibility* (2016), [http://www.aph.gov.au/Parliamentary\\_Business/Committees/House/Economics/Taxdeductibility/Report](http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/Taxdeductibility/Report). See Coorey, P ‘Government considers trading tax breaks for lower rates’ (1 December 2015), *Australian Financial Review*, <http://www.afr.com/news/politics/government-considers-trading-tax-breaks-for-lower-rates-20151201-gld12x>.

<sup>133</sup> Standing Committee, *Inquiry into Interest Deductibility*, above n 130, [http://www.aph.gov.au/Parliamentary\\_Business/Committees/House/Economics/Taxdeductibility/Report](http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/Taxdeductibility/Report) (accessed 9.10.17).

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'.<sup>134</sup>

Other submissions to the inquiry strongly opposed the abolition of interest deductibility.<sup>135</sup> They drew on Ernst and Young modelling showing a rise in effective tax rates under this option; in EY's view we have a structural over-reliance on corporate tax, so self-funding changes to the headline rate do nothing to address the real issue.<sup>136</sup> We are sceptical of this view since the structural over-reliance on corporate tax reduces once we net out imputation credits from the corporate tax take. If the interest deduction were abolished in the context of our imputation system, the change effectively alters the definition of the corporate withholding tax. However, it would not impact on the effective tax rate on corporate investment, which for domestic investors is mostly dictated by the personal income and capital gains taxes (abstracting from timing issues).<sup>137</sup>

## 7. Hybrid corporate tax base reforms

We finally turn to a range of 'hybrid' models for corporate tax base and corporate-shareholder reform. Two plausible combinations could be an ACC (or ACE) combined with a CBIT; a dual income tax at the corporate and personal level, that may over time approach a CBIT; or the limiting or denial of interest deductibility combined with the removal of the imputation system. We briefly discuss these three hybrid options here.

### 7.1. *The combined ACE-CBIT*

Various authors have suggested that the ACC or ACE could be combined with the CBIT. This reflects a simultaneous move to reduce interest deductibility while also reducing the tax burden on equity finance through a partial deduction for the cost of equity. It could combine the fiscal sustainability and the efficiency benefits of each approach, calibrating the taxation of capital income at a lower tax rate.

De Mooij and Devereux modelling suggests that it is possible to combine ACE and CBIT to achieve financing neutrality (and lower corporate tax rates), with small net gains to welfare. They observe:

'The results suggest that ACE is welfare improving as long as corporate tax rates are not used to cover the cost of base narrowing. CBIT typically reduces

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<sup>134</sup> Treasury Submission to Standing Committee, *Inquiry into Interest Deductibility*, above n 130, [http://www.aph.gov.au/Parliamentary\\_Business/Committees/House/Economics/Taxdeductibility/Report](http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/Taxdeductibility/Report), p. 10-11 (accessed 9.10.17).

<sup>135</sup> See e.g., AVCAL (Australian private equity and venture capital association limited), Submission to the Standing Committee on economics Inquiry into tax deductibility' (2016) and APPEA (Australian petroleum and exploration association limited), Submission to the HR Standing Committee on economics Inquiry into tax deductibility (2016).

<sup>136</sup> EY (Ernst and Young) Submission to the Standing Committee on economics Inquiry into tax deductibility (2016).

<sup>137</sup> However, the Ernst and Young EMTR results are consistent with other CGE models such as De Mooij R and Devereux M 'An applied analysis of ACE and CBIT reforms in the EU' (2011) *International tax and public finance* 18, 93-120.

welfare by exacerbating marginal investment distortions. When governments adjust statutory corporate tax rates to balance their budget, however, CBIT reforms become more attractive while ACE reforms are welfare reducing in a number of countries. ... A combination of ACE and CBIT reforms can be designed to be revenue neutral and welfare improving through smaller financial distortions.<sup>138</sup>

In their calculations, De Mooij and Devereux suggest that revenue and finance neutrality could be achieved with a 2/3 ACE and a 1/3 CBIT. In Australia, neutrality might be achieved with a 50/50 ratio. The implication for corporate tax revenue is meant to be offsetting, although this varies as between the countries studied. Overall the cost of capital falls slightly and investment rises slightly: 'For many western countries, the revenue-neutral combination of ACE and CBIT outperforms either ACE or CBIT' alone.<sup>139</sup>

The combined ACE-CBIT could bring benefits in terms of reduced leverage, reducing systemic risk and reducing profit shifting (by bringing gearing close to its efficient level), suggesting that a cross-border ACE-CBIT could make the 'rules surrounding the existing thin capitalisation rules redundant, thereby simplifying this area of tax law'.<sup>140</sup>

## 7.2. *The CBIT and dual income tax (DIT)*

Crossen has supported a CBIT in the EU context as a means of standardising the effective tax rate on various forms of capital income; this would create a flat tax rate on interest and dividend income which is a form of dual income tax (DIT).<sup>141</sup> The Nordic countries, and the Netherlands, have successfully implemented different versions of a DIT. The DIT still allows a deduction for interest expense (though often quarantined to capital income and gains).

A dual income tax has the feature that a single flat rate is applied to capital income; at the personal level it is the natural counterpart of the CBIT. The corporation effectively pays tax on interest and dividend income and if these two are exempt at the personal level then the corporation tax rate is the effective flat tax on capital income (including retained profits). It only remains to apply the same rate to non-corporate-sourced capital incomes. Overall, capital income is taxed at a moderate, uniform rate, whereas labour income continues to be taxed under a progressive rate scale.

Under Crossen's proposal, withholding taxes on interest and dividends would be gradually raised to the level of the DIT rate, which would convert the dual income tax into a CBIT.<sup>142</sup> Interest and royalties would not be taxed again in residence countries. A key reason for the change is the international context:

'As befits its pedigree, the original CT was largely designed for economies in which cross-border transactions were the exception rather than the rule, in

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<sup>138</sup> de Mooij and Devereux (2009), above n 81, p. 1.

<sup>139</sup> de Mooij and Devereux (2009), above n 81, p. 91.

<sup>140</sup> Kayis-Kumar, above n 74, p. 35.

<sup>141</sup> Crossen, above n 66.

<sup>142</sup> Crossen, above n 66, p. 24.

which debt could be distinguished clearly from equity, and in which shareholders were natural persons generally residing in the country in which the corporation had been established. In such economies, CTs were meant to be a schedular tax on the equity income of shareholders, that is, profits. Interest was deductible in ascertaining profits and was taxed in the hands of the debt-holder. But globalization and capital market liberalization and innovation have turned this traditional CT model on its head. Debt has become largely indistinguishable from equity through the use of financial derivatives and hybrid instruments. Unlike equity income, interest is not taxed at the corporate level and may not be taxed at all if it accrues to foreign debt-holders or exempt entities. This discrepancy in the treatment of returns that are largely identical suggests that equity income and interest should be taxed alike at the level of the corporation.<sup>143</sup>

As Cnossen notes, unlike the dual income tax, the CBIT has not been introduced in any country, 'presumably because of its effective taxation of all interest whether paid to domestic or foreign bondholders. Taxing foreign bondholders might deter inward capital flows.'<sup>144</sup> This is, as discussed above, an issue with Australia's current corporate tax; we note that the CBIT has the apparent advantage of deterring equity and debt inflows by precisely the same extent and, as noted, at a lower tax rate.

A well-known difficulty in designing the DIT is that small partnership and company incomes comprise a mix of personal exertion income (ideally taxed at personal tax rates) and capital incomes, but various formulae can be applied to separate out the various components of income and thereafter apply the appropriate tax rates. These formulae are somewhat arbitrary and not completely satisfactory. Nonetheless, Cnossen concludes that the dual income tax is 'best attuned to the reality of capital mobility' and in this way, 'minimises the opportunities for tax arbitrage'.<sup>145</sup>

The most potent objection to the dual income tax/CBIT concerns progressivity, as the top tax rate on capital income is constrained to the company tax rate. Ending imputation and substituting a percentage discount for dividends and interest flattens the effective tax rate structure on capital income. Achieving a political consensus for a CBIT or a dual income tax in Australia might appear to be challenging, given our tradition of progressive individual income taxation. However, we observe that it is likely that many high income individuals who have capital income would already be utilising corporate, trust and superannuation fund vehicles, as well as the CGT 50 per cent discount, to cap their tax rate on capital income and gains. Australia's diverse effective tax rates on different forms of personal saving mean it is possible to structure a low effective rate for much capital income.

It would be possible to combine a CBIT with some taxation of dividends and interest at the personal level, which would retain some degree of double taxation. This taxation might be at less than full rates; for example a discount of 50 per cent (or a lower discount rate) might apply to dividend and interest income, to match the current capital gains tax discount. A similar approach is suggested by the Henry Tax

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<sup>143</sup> Cnossen, above n 66, p. 3.

<sup>144</sup> Cnossen, above n 66, p. 99.

<sup>145</sup> Cnossen, S 'What Kind of Corporation Tax Regime?' (2014) CESifo Working Paper Series No. 5108 December 18.



Review (at a 40 per cent discount) in order to smooth effective tax rates on different forms of capital income.

### *7.3. Limits on interest deductibility and removing imputation*

In Part 6, we discussed the many issues with the corporate interest deduction in an international context; the bias that is embedded by our current imputation system; and the increasing trends towards limiting interest deductibility around the world.

It is clearly open to the government to further limit interest deductibility through a stronger thin capitalisation rule or other limits. This could, over time, be part of a phased move towards a CBIT, with an end to imputation and a uniform percentage discount on corporate sourced interest and dividend income. As discussed in Part 2, modelling suggests that “half franking”, in effect replacing dividend imputation with a discount for dividends at the shareholder level, would finance a corporate tax rate reduction to 25 per cent. Limiting debt deductibility would further lower this rate.

Assume taxpayers with marginal personal tax rates of 0, 15 (superannuation funds), 35, and 50 per cent. These would be the current effective tax rates on dividends. Without dividend imputation and applying a 20 per cent corporate tax rate, these personal tax rates rise to 20, 32, 48 and 60 per cent. To keep the top rate at 50 per cent we need at least a 25 per cent discount for dividend income in shareholder hands, producing rates of 20, 29, 41 and 50 per cent. A consequence is that the tax cut for foreign owned corporations would be largely financed by higher taxes on current low marginal rate taxpayers, including (notably) superannuation funds.

The removal of imputation and enactment of a lower corporate tax rate, allied with a 25 per cent discount for dividends in the hands of the shareholder, moves us towards a dual income tax with an effective tax rate ranging from 20 to 50 per cent. This would produce significant positive tax rates on capital incomes, even for low rate taxpayers. This would be of benefit for several reasons. First, many low rate taxpayers are using structures which artificially lower their tax rate, like trusts and super funds, and this reform would ensure a minimum tax on dividend distributions - assuming that corporations do continue to distribute dividends (rather than simply retaining profits). Second, capital income and gains outside the family home are in any case overwhelmingly held by the well-off and should be subject to tax. Third, a redistributive system can be established through tax-transfer settings including ensuring a broader base for taxing capital income and wealth as well as the progressive tax on wages.

## **8. Conclusion and directions for reform**

The Australian Government proposes to reduce the Australian corporate tax rate from 30 to 25 per cent. To date, it has not succeeded in obtaining political support for an across-the-board rate cut. Instead, the government has so far legislated a partial and highly complex lower tax rate for small and medium companies doing ‘active’ business, to be phased in for businesses with turnover up to \$50 million.<sup>146</sup>

This article has proceeded on the basis that Australia will face increasing pressure to cut the corporate tax rate and that it cannot continue indefinitely to be a global outlier on this headline tax parameter. The corporate tax has traditionally been a means of

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<sup>146</sup> Australian Taxation Office, <https://www.ato.gov.au/General/New-legislation/In-detail/Direct-taxes/Income-tax-for-businesses/Reducing-the-corporate-tax-rate/> (accessed 6.10.17).

ensuring that foreign investors contribute to Australia's economic welfare. The cost of capital of Australian firms has been lowered in the past - for debt capital - by generous interest deductibility for cross-border borrowing. However, this approach is no longer satisfactory given the opportunities opened up for tax planning and that the corporate tax rate is increasingly uncompetitive relative to a global environment.

In the short term, we argue that it is possible to reduce the headline rate of corporate tax in a revenue-neutral manner by eliminating or reducing dividend imputation. In the medium term, Australia could aim to reform the corporate tax base. One option is to enact an ACE/ACC which would in theory be more efficient, but would narrow the base at a fiscal cost and is also likely to increase cross-border tax planning opportunities. An alternative could be an ACE that is levied on top of the corporate income tax (which could then have a lower rate), targeted at taxing 'super-profits' of resource and financial firms. This would have positive economic effects, but would still need to be financed by bracket creep in the income tax or by other taxes, such as a higher rate GST.

Alternatively, Australia could broaden the corporate tax base combined with a lower rate, with the goal of achieving a more coherent tax system for capital income in the corporate and personal income tax. This could be done through limiting and perhaps ultimately removing, interest deductibility by applying a CBIT while replacing dividend imputation with a discount for dividends and interest at the shareholder level. This option could be combined with an additional rent tax on super-profits of banks and the resource sector. It would move the corporate tax towards financing neutrality and would reduce opportunities to manipulate tax burdens at the corporate level, while using the broader corporate tax base to finance reduced taxation of interest income and other savings. This could finance a significant reduction in the headline corporate tax rate, which would further reducing profit shifting and encourage foreign investment. Such a reform would be economically and fiscally beneficial for Australia.