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What future for the corporation tax?

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Abstract

Corporation taxes are under pressure from a number of sources. This paper looks at the arguments for and against corporation tax in the context of Australia, which has had for 30 years a dividend imputation system for corporate-shareholder taxation. Corporation tax is estimated to have a high economic cost relative to the revenue raised; there are worries about base erosion and profit shifting (BEPS); and there are suggestions that dividend imputation should be abolished to allow a lower corporate tax rate. The imputation system and discount for capital gains tax largely eliminates the corporation tax for Australian domestic investors, so that the effective tax on domestic corporate investment is indicated by personal income and capital gains taxes. Hence the Australian corporation tax is mainly a tax on foreign investment. In an era of mobile international capital this role is increasingly problematic. In the long run, the corporation tax may wither away due to international tax competition and BEPS. This may be an acceptable development provided that, as this happens, we put in place a stronger system of personal taxation of capital incomes, with international co-operation in the discovery and valuation of such incomes. We can also rely on consumption tax, such as the Goods and Services Tax (GST), or a business cash flow tax, to tax part of corporate sector economic rents.

Keywords: Corporation tax, dividend imputation, base erosion, personal income tax

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Contents

1. Introduction

Corporation tax (CT) has come into the headlines in Australia as a result of the Turnbull Government's policy of reducing the CT rate in phased steps (over 10 years) from 30 to 25 per cent. This policy has generated much controversy. There has also been significant policy and administration activity, and news headlines, about base erosion and profit shifting (BEPS) by multinational corporations. Further, it might be queried whether, in 2026, a 25 per cent rate might still be in the upper half of the range of CT rates levied by Australia's major investment and trading partners. There appears to be a 'race to the bottom' which may be joined now by the US under the Trump policy of reducing the CT rate to 15 per cent and Republican Party proposals for a 20 per cent rate.

1.1. CT revenue

Corporation tax is a relatively large source of revenue in Australia, raising about $70 billion per year (Treasury 2015, Chart 2.6 p. 21), about 6 per cent of GDP, 15 per cent of total government revenue (all levels) (ABS 2017)[1] and 19 per cent of Commonwealth revenues.[2] The proportion of CT in the tax mix in Australia is high compared to the OECD average of 8.5 per cent of revenue or just below 3 per cent of GDP (Treasury 2015, Chart 5.3 p.76). However due to dividend imputation the Australian ratio is inflated, as explained below, such that its real take is closer to the OECD average.

The Australian CT rate of 30 per cent is high relative to the OECD average of approximately 25 per cent. (It is now 27.5 per cent for small and medium enterprises, to be phased in for SMEs up to $50 million turnover). CT rates are tending to fall around the world (Treasury 2015 Chart 5.1 p74).[3] The United Kingdom has reduced its rate to 20 per cent with further reductions planned to take it to 17 per cent. Ireland, to the dismay of the EU, has a rate of 12.5 per cent for trading income; in light of the recent dispute about Apple, the effective rate for some corporations may be much lower than this.[4] The United States (US) may reduce its (relatively high) rate from 35 per cent.

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[1] Income taxes on enterprises, including taxation of superannuation funds

[2] Treasury 2015 chart 2.6 p21 shows 22 per cent, but 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.

[3] PwC (2015) state that our peer rate is 23 per cent.

[4] https://www.bloomberg.com/news/articles/2016-12-16/the-inside-story-of-apple-s-14-billion-tax-bill

This means that the relative competitiveness of our CT regime has been declining (Mintz et al 2016 pp.4, 14). However, around the world, total CT revenues are not falling nearly as fast as CT rates, due partly to base broadening and partly to rising corporate shares in total profit (Sorensen 2007 p180). Australian CT revenue has been high in recent years not only because of the tax rate, but also because of the high corporate profit share – elevated in part due to the mining boom. This share has fallen back, but may be set to rise again with the recent strengthening of commodity prices.

1.2. The Australian dividend imputation system

Australia has a full corporate-shareholder imputation system for domestic corporate profits and resident shareholders. Foreign profits and non-resident shareholders do not benefit from the imputation system.

Imputation (franking) credits are distributed to shareholders along with dividends and their taxable income is the combined amount. Tax payable then takes account of tax prepaid by the company, as measured by the credits. If franking credits exceed tax payable, a refund is due to the taxpayer. Under this system, the CT is essentially converted into a withholding tax (Sorenson and Johnson 2010 p. 205). The ultimate tax burden is the same as if the shareholders had earned the business income directly, and the CT is essentially a pre-payment of individual income tax. Hence there is no 'double taxation' of corporate profit, which is a feature of 'classical' CT systems which tax corporate profit at the company level and again when distributed as a dividend.

Dividend imputation was introduced by Paul Keating in 1987 in Australia, but credits were not refundable at that time. The elimination of the double taxation on dividends produced by dividend imputation helps create neutrality as between equity and debt financing (as interest is deductible and taxable at the individual level). The system was reformed in the early 2000s to make franking credits refundable for individual taxpayers. Cooper (2011 p13 fn. 106) notes:

> *'The move to make surplus franking credits refundable in cash from 1 July 2000 was fundamentally important because it changed the corporation tax from a final tax to a withholding tax, at least for resident investors… [Hence its impacts] are largely confined to investments financed by foreign investors or retained profits.'*

Franking credits are only available for CT paid in Australia and are not available for income earned offshore. On Treasury figures, an estimated $12 billion (30 per cent) of the $40

billion imputation credits distributed each year are received by non-resident shareholders (Treasury 2015 p.83) and hence are 'wasted'. Over the four years to 2013-14, franking credits claimed by domestic investors averaged 36.3 per cent of total CT revenue (Minifie 2017 p.59). Estimates of the degree of overseas ownership of Australian companies vary but are in the range of 20-40 per cent (see Ainsworth et al 2016 p.43). On the other hand there is substantial overseas investment by Australian companies.

Around $4.6 billion in credits were refunded for the 2012-13 tax year (Treasury 2015 p.86). Treasury suggests that '*There are some revenue concerns with the refundability of imputation credits… it provides a greater incentive for shareholders of closely-held companies to delay distributions until a time when individual owners are subject to a relatively low tax rate, to receive a refund of tax paid by the company. A similar incentive also exists under classical systems' (Treasury 2015 p.86).* It is estimated that about one quarter of dividends are unfranked (Freebairn 2015 p.361) and that companies pay out around 70 to 80 per cent of after-tax earnings as franked dividends, while around 80 per cent of the franking credits are used by shareholders to reduce their tax payable (David 2012).

Imputation and refundable credits have basically abolished the CT for Australian taxpayers, except for the delay until franked dividends are paid. This delay can be significant, and shows up in the statistics. For example in 2013-14 CT of $69 billion compared with franking credit claims of $21.6 billion (Murphy 2016a p.3). Accumulated franking credits have built up over time and are now worth almost $300 billion. Because no interest is payable on franking credits their real value decays over time.

When companies pay tax, they enter a corresponding imputation credit in their franking account, which can be debited with a franking credit on dividends paid to their shareholders. In some circumstances the franking credit can be distributed on 'deemed' dividends, e.g. in the case of structured off-market buybacks of shares. The result is that, for domestic shareholders, the franking credits are almost as good as cash. They are not quite as good – companies tend to squirrel away franking credits in their franking account to tide them through times when their dividends might not otherwise be fully franked, and these accounts are in effect an interest-free loan to the Tax Office – but they are almost as good.

However, it is not clear to what extent the market takes account of credits in making investment decisions; Treasury suggests that franking credits may not be fully valued in the

stock market, and that the share market may only value half of franking credits (2010b). This is consistent with the findings of Ainsworth et al (2015). Less than full valuation raises questions about the cost effectiveness of the franking regime.

If individual investors effectively get a cash refund for CT paid, no effective tax burden results from the CT. This means that the relevant tax for individual investors is the individual income tax (including the capital gains tax) and not the CT. Distortions in the company tax (such as difficulties in accurately measuring true economic profits) are over time washed out by the combined CT and individual income tax. As Treasury notes, '…the final tax on company profits reflects each shareholder's tax rate' (Treasury 2015 p83).

Considered in this light, the CT can be thought of as a sort of random withholding tax at the corporate level, offset by taxes at the individual level. I use the word 'random' to reflect the fact that the CT measure of corporate income is only imprecisely related to true economic profit, due to the difficulty, under an income base, of measuring such profits.

1.3. Current Government Policy

The current Government, in the 2016 Budget, promised to reduce the CT rate to 25 per cent over 10 years at a total cost of some $50 billion. This figure is not very useful, however, as it does not tell us the annual cost which Murphy (2016a) estimates will be some $8.2 billion per annum at the ten year mark. This includes lost revenue of $11.3 billion partly offset by a reduction in the value of franking credits of $3.1 billion. Murphy estimates a further offset of up to $4.5 billion due to 'self-funding' (see Murphy 2016a p4), leaving an annual revenue gap of $3.7 billion. Minifie (2017) estimates a cost of $7.4 billion. These are cash costs; there is a case for looking at these costs on an accrual basis, which may lower them somewhat.

The phase-in method proposed was that the concessional rate of 27.5 per cent for small business with turnover under $2 million per annum will be extended to progressively larger business over time, reaching $1 billion turnover in the 2022-23 financial year, and then all companies in 2023-24. Then the CT rate will reduce to 25 per cent in steps, reaching that rate in 2026-27. However there is parliamentary (Senate) opposition to all except the first steps in this reduction, and there is currently to be no reductions for firms with over $50m in turnover. Those benefiting are quite small companies, so the bulk of revenue is unaffected.

There has been an argument between proponents and detractors of the Government's proposal, in particular in relation to the GDP growth effects and the Marginal Excess Burden

(MEB) estimated for the CT (e.g. Murphy 2016a,b and c and Dixon and Nassios 2016). The Government maintains the full change would boost GDP by more than 1 per cent in the long-term, at a budgetary cost of $48.2 billion over the next 10 years. However, Daley and Coates (2016) suggest that the Treasury research papers relied on by the Coalition tell a more modest story than the headlines. Minifie (2017) (also from the Grattan Institute) suggests that a 5 per cent CT rate cut would increase foreign direct investment by only 0.4 per centage points of GDP, consistent with Treasury's model (2017 p32). Although GDP is raised, on the Treasury numbers, about one third of that benefit flows to foreigners. Another part of the benefit is dissipated in the higher taxes needed to finance the CT cut, as the modelling assumes a non-distortionary lump sum tax replaces the CT. The net benefit to Gross National Income (GNI) (Daley and Coates' preferred measure) is then only 0.6 per cent after 25 years. If Australian per capita GDP and GNI increase at 1.5 per cent a year (as the budget papers routinely assume), then over 25 years, incomes will rise by 45.1 per cent. The CT rate cut modelling implies that instead, incomes will rise by 45.7 per cent.

In a like vein Daley and Coates examine the Government claim that there will be a $4.30 increase to GDP from each $1 in revenue cut. Leakage to foreigners reduce this to $2.80. Distortions due to financing through the income tax further reduce it to $1.80. Taking account of timing, they suggest 'the increase to Australian incomes in the long term is only $1.20 for every dollar given up in the short term as a result of corporate tax cuts', and net benefits take 19 years to materialise.

Dixon and Nassios (2016b) suggest the 'current rate of company tax at 30 per cent is almost certainly close to its optimal rate'. In their view the correct question is not whether the MEB of CT is higher than for other taxes, but what is the optimal CT rate given that any reduction in the rate is a gift to the '20 per cent of capital which is foreign owned, and willingly installed under the present tax regime'. Loss of gross national income to foreigners then needs to be balanced against reduction in our attractiveness to new foreign capital – an optimisation problem.

Let us here introduce some caveats. Modelling, while interesting and instructive, cannot really tell us what is the 'right' rate of CT. Ultimately, there will need to be a heuristic judgement based on what we can sustain in the face of international tax competition and BEPS. While we can counter BEPS to some extent by tighter administration, there are limits

as to how far this can be effective, and there are real issues of complexity and administrative costs which arise from addressing BEPS administratively.

In all CGE study results, impacts on GDP and GNI over time from CT cuts of 5 per centage points are comparatively modest (typically around 1 per cent of GDP), and slow in coming. We can be sceptical that they fully encompass the dynamic costs of having an (increasingly) uncompetitive CT rate.

1.4. The effect on fiscal cost and investment taking franking into account

Franking complicates the task of estimating the cost of CT reductions. In an accrual accounting framework, the cost of abolishing the CT is reduced in proportion to the share of domestic ownership, which is around 70 per cent.[5] On the other hand, an extra cost must be added back in to reflect wastage of credits and the interest-free loan to the Treasury.[6] This implies in effect that we are over-counting corporate tax revenue, and up to half should really be attributable to individual income tax.

At least for resident shareholders, the economic incentives to invest through corporations are determined by the individual income and capital gains tax. It is possible however that firms don't 'look through' to the personal level in making economic decisions (Ainsworth et al 2015). In Murphy's view (2016c) imputation adds to the inefficiency of the CT by reducing revenue while having little impact on aggregate investment, as the marginal suppler of capital is the foreign investor so that investment yields are set in international markets. Imputation is thus a net subsidy to domestic investors.

The key point is that the company tax in a full imputation system (with refunds) is mainly a tax on foreign corporations and foreign ownership of domestic corporations. This sounds good, but it may not be.

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[5] If we attribute the 30 per cent fraction to the company tax take of $70 billion we get a net yield of $21 billion. Freebairn (2015a p.361) states that about one half of shares in Australian corporations are owned by residents and one-half of corporate after tax income is distributed as dividends.

[6] Sorensen and Johnson (2010 p179) suggest that non-residents own around 30 per cent of equity in Australian companies. Cao et al (2015 p9) suggests that the figure is 20.7 per cent. Dixon and Nassios (2016b) use this figure. There is also an interest-free loan to the Government worth, at the moment, around $8 billion per annum and some wastage of franking credits (say, $5 billion) for a total of $34 billion, which may be close to the accrual accounting cost of abolishing the company tax. There is also the complication introduced by the dividend payout ratio, which is currently around 75 per cent.

2. Inefficiency or excess burden of the CT

The CT is said to have a high MEB, or economic cost, 'because of the relatively high company tax rate of 30 per cent in Australia, combined with the high level of mobility of the underlying tax base' (Treasury 2015 p24). The MEB of the company tax is shown as 0.7 in Re:think (Treasury 2015 Chart 2.9). That is, raising an additional dollar of revenue from this source costs the economy 70 cents. This can be contrasted with the estimated MEB for a linear income tax or the GST of around 0.25. Cao et al (2015 p20) put the CT MEB at 50 cents, largely borne by workers in the form of lower real wages. Murphy (2016c) estimated the MEB at 139 cents.

2.1. Incidence of CT

One typical result for CT in the optimal tax literature is that a small open economy should not apply a source-based tax on the normal rate of return on mobile capital. If capital investment is perfectly elastic or capital is perfectly mobile, such a source-based tax is fully shifted onto immobile factors of production via an outflow of capital which drives up the pre-tax return to capital (Brekke et al 2015 p15).

Freebairn (2015a p363), while rejecting the assumptions underlying the hypothesis of full burden shifting, suggests that much of the short-term benefit of a CT rate cut goes to foreign shareholders. However he concludes that in the long run[7] these benefits are eroded, as half or more of the benefits manifest in higher wages: i.e. the gross benefits are roughly split between (foreign) shareholders and labour. Other studies (summarised in Mintz et al 2016 p8) show even higher burdens on wages; hence the 'company tax is a clumsy instrument to achieve progressivity since it is not the company that bears the tax' (Mintz et al 2016 p9).

On the face of it, this would appear to imply that the CT should be reduced with the revenue to be made up by, say, raising the GST and this would produce a substantial net economic benefit. This has been done (in part) in Italy for example (Bordignon et al 2000) and has been advocated in the United States (but using the term 'business flat tax' or 'business activity tax').[8] This is a key argument for the cut to CT in Australia. It has been advocated,

[7] The long run can be between 10 and 30 years, according to some estimates: Freebairn (2015a p362).

[8] http://www.wsj.com/articles/value-added-tax-catches-on-in-republican-presidential-race-1447374891

for example, by advisory firm PwC in a November 2015 brief on company tax[9] suggesting that a cut in the rate to 25 per cent would deliver the economy a growth dividend that would generate enough extra tax to pay for itself inside of 5 years. As Richardson (2015 p12) has pointed out, this immediately reminds us of the ill-fated 'Laffer curve'; however many modellers believe that a tax clawback of up to half the gross cost is realistic.

Australian studies have suggested that up to half the cost of abolishing the corporate tax might be recouped as a result of additional economic growth, after 10 years. For example Murphy 2016a suggests that in the long run 55 per cent of the cost is self-funded, and that this is in line with other studies such as UK Treasury 2013. This modelling for the large reduction in the UK company tax rate (28 per cent in 2010 to 20 per cent by 2015-16) indicates that the policy 'shows increased profits, wages and consumption all add to higher tax revenues. As a result the cost of the policy falls by between 45 per cent and 60 per cent in the long run' (p3). In Kouparitsas et al 2016 (p29), a Treasury study for Australia, the cost falls by 35-50 per cent.

However, full transition to the new equilibrium state can take up to 30 years (Freebairn 2015a p362). Kouparitsas et al 2016 note other studies which suggest that roughly half the adjustment is completed in ten years, with the full adjustment largely completed by 20 years (2016 p6).

In the short term the revenues would have to be made up through e.g. a GST rise, which creates its own issues of compensation and/or possible unfairness.[10] In particular it burdens domestic consumers in order to (apparently) benefit foreign shareholders, and hence is politically difficult.

The efficiency results are also contested. Clausing (2012) has questioned whether the empirical studies showing that the CT reduces wages are really robust and in her study finds little impact. She also suggests that the policy implications from these studies are unclear (2012 p5).

Another complication is that when profits are repatriated to a worldwide taxing country such as the US (our largest single source of in-bound investment), rather than reinvested in a

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[9] http://www.pwc.com.au/press-room/2015/company-tax-cuts-nov15.html see also https://pwc.docalytics.com/v/pwc-protecting-our-prosperity-corporate-rate-reduction

[10] Freebairn (2015a p357) briefly surveys the incidence literature; in terms of revenue his own study suggests that in the long run about one third of the first round loss of government revenue is recaptured. Both the revenue and the incidence estimates are sensitive to key parameters used in the modelling (p366).

source country like Australia, we can impose a source tax up to the limit of the US foreign tax credit without reducing the incentive for inbound investment from countries with a credit system. Whatever the theoretical merits of reducing the CT rate, if this occurs, it may result in a transfer of revenues to foreign treasuries and limit the net benefit for Australia.

Richardson (2015 piii, 2016) argues that if the rate is reduced, the US, or other foreign tax authorities are likely to gain at the expense of the ATO because of arrangements to relieve double taxation under the bilateral treaties Australia has with many countries. However, this would only be the case if the investor's host country has a foreign tax credit system instead of a territorial or exemption system for relieving double taxation. The impact is muted to the extent that US companies choose not to repatriate offshore profits but instead hold them untaxed offshore. Based on US foreign tax credit statistics, Richardson (2016) estimates a net benefit to the US Treasury of $730 million per annum from the Government's proposed 5 per cent CT cut. This translates into some $5 billion if the CT is abolished, or 7 per cent of total CT revenue. Murphy (2016c p5) estimates that no more than 5 per cent of total CT revenue is impacted by the foreign tax credit effect.

Arguments about foreign tax credits are becoming less relevant in today's world where most other countries have an exemption or territorial based system of relieving double taxation, where they have a lower CT rate than Australia, and where base erosion and profit shifting (BEPS) has grown in importance. In this context, the argument for reducing the headline rate of CT has become more salient.

2.2. METR may be a better measure of tax distortions than the CT rate

Mintz et al (2016) use the Marginal Effective Tax Rate (METR) to compare CT burdens in different countries. This is the tax paid as a proportion of pre-tax profit for profitable new investments. METRs are affected by factors like the depreciation regime and the tax deductibility of interest expense (which is limited in many countries by 'thin capitalisation' rules). Mintz et al find that for Australia, the METR on non-resource capital investment was unchanged between 2005 and 2015, at 25.7 per cent; across 34 OECD countries the average METR has fallen from 21.4 per cent to 17.7 per cent in the same period. However the figures relate to the CT only and do not factor in imputation. Imputation can be disregarded if the rate of return to investment is set by the marginal foreign investor, which is the Treasury view (for a more nuanced view see Ainsworth et al 2015).

Possible measures to fund a reduction in the headline CT rate include base broadening, for example by phasing out the deductibility of interest expenses under a CBIT (comprehensive business income tax) system. This trade-off would not reduce the aggregate METR on new investment, and for investment which is financed out of borrowings may actually increase it. If the METR is the policy concern, this can be reduced by accelerated depreciation or by investment allowances. As this only benefits new investment, it may be cheaper (at least in the short term) than a CT rate cut which benefit old and new investment alike. Modelling by Radulescu and Stimmelmayr (2006) shows that the combination of reduced interest deductibility and accelerated depreciation can be potent; this approach is part way towards the cash flow corporation tax (CFCT) which allows full expensing - 100 per cent depreciation. In the R(real)-CFCT there are no deductions for interest costs.

Another possibility is that dividend imputation could be abandoned or modified. This could finance a large cut in the CT rate (possibly to 20 per cent), attenuated by the need to provide some discount on dividend income. Such an approach could help maintain a competitive CT rate over the medium term which, as the Government's current policy attests, will come at a cost to revenue. However, further cuts to the headline rate and to METRs may be necessary in the long term because international tax competition will likely keep pressure to drive rates down.[11]

In the very long term, I see this process culminating in the near-abolition of the separate CT. As discussed below, it could be replaced by a more comprehensive regime for the taxation of capital incomes at the individual level.

2.3. CT rates in the context of BEPS

The issue of BEPS creates the background against which we need to evaluate CT reform proposals. BEPS is a high-profile project of the OECD and G20 (2013, 2015). The globalised economy has increased the opportunities for multinational companies to use legal means to minimise their tax liabilities through BEPS. The G20 is co-ordinating a response to BEPS, and G20 leaders approved an overhaul of international rules in 2015.[12] The OECD internationally and Australia domestically are trying to increase country co-

[11] Unless of course there were some sort of international agreement on the CT rate. Even in this world, there would be incentives for countries to cheat by eroding the CT base – e.g. using accelerated depreciation.

[12] Hannon and Rubin 'G20 leaders to approve tax dodge crackdown' in the Australian 16 Nov 2015

operation to address BEPS (Stewart et al 2015 p58; Stewart 2012). According to Vann (2014 p435), on the OECD action plan:

> *'The basic BEPS policy problem is defined in the action plan as follows: 'No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.'*

Vann observes further that

> *'The corporate income tax is primarily a source-based income tax, making it vulnerable in two directions: to tax planning aimed at moving the source of the income without moving the activity; and to movement (relocation) of the activity because of the international mobility of capital' (2014 p436).*

Many tax planning devices are used to minimise taxes by multinational corporates including famously the 'double Irish-Dutch sandwich' (see e.g. Stewart et al 2015 p67) which exploited the low Irish CT rate. But this is just the tip of a large iceberg. Recent court cases involving the ATO and large companies in Australia (e.g. Chevron, Orica, and BHP) have illustrated the aggressiveness of company tax planning methods using for example inflated inter-company interest charges or offshore 'marketing hubs' in low tax countries. Zucman has suggested that about 20 per cent of US corporate profits are now booked in tax havens and the effective US corporate tax rate has declined from 30 to 20 per cent over the past 15 years, with two thirds of this decline attributable to profit-shifting to low-tax jurisdictions (2014 p121).

Aggressive tax planning is one way for companies to get around the high costs of equity capital under the corporation tax, thus neutralising some of the supposed disadvantages of the CT in terms of capital inflow (Vann 2013 p72). However, once started it is hard to put a limit on this process. Kleinbard (2011) argues that the global companies have become adept at the creation of 'stateless income', meaning that some of their activities pay no tax at all.

Devereux and Vella (2014 p4) suggest that the OECD BEPS initiative is essentially seeking to close some loopholes in the international tax system for corporations, rather than to re-examine the fundamental structure of the system. They criticise the current system as based on an arbitrary allocation of taxing rights stemming from agreements in the 1920s

and being prone to tax competition between governments – i.e. the 'race to the bottom'. They also suggest that 'the proposed solutions are likely to be undermined by tax planning and to create real economic distortions' (Devereux and Vella 2014 p17). The authors canvass more fundamental solutions such as formulary apportionment,[13] allocation of tax base based on the location of sales to third parties, and a simpler tax base such as one based on turnover, size of fixed assets, sales or wage costs. While all these are arbitrary, they may not be more arbitrary than the current system.

The ATO is addressing base erosion by legal and administrative measures, such as the diverted profits tax (DPT) and the multinational anti-avoidance law (MAAL). The MAAL targets foreign corporations selling to Australians but avoiding establishing an economic presence here, and therefore enables Australia to tax them. The DPT is an attempt to tax multinationals and Australian companies such as the big miners, which have been accused of channelling profits through Singapore using marketing hubs.[14]

In light of the ability for multinational corporations to do BEPS and reduce their tax, Adam et al (2015) have doubts whether source-based corporate taxation can endure in the long run. Transfer pricing is a key problem. A multinational corporation may, for example, have laboratories in several countries, each contributing to a unique product, and for which arm's length pricing (as suggested by current rules) is simply a mirage. Hence:

> *'…maintaining a source-based corporation tax introduces problems in the international allocation of profits to which there is probably no solution in principle… complex rules, uncertainty and 'manipulation' of accounts to show profits in low tax jurisdictions are probably inevitable.' (2013 p5-6)*

Murphy's (2016c) finding that CT has a high MEB in Australia relates partly to profit shifting to lower tax jurisdictions, 'which wastes resources on tax avoidance and erodes the revenue base' (p5).

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[13] Under a formulary system worldwide income is allocated to individual countries by a formula that reflects their real economic activities: Clausing 2012 p33

[14] 'Australia hits 'low' on corporate tax' J Mather AFR 10.2.17 http://www.afr.com/news/politics/australia-hits-low-on-corporate-tax-20170208-gu8ui9. See also http://www.afr.com/news/politics/diverted-profits-tax-draconian-20170104-gtm6kh on that date.

3. Why do we tax corporations?

Since CT is eventually passed on to individuals in some form, we might question why we tax corporations at all. Certainly there is a lot of cost and complexity involved in this endeavour. There is a body of literature in the modern economic vein which argues that in today's globalised open economy it is not possible to tax corporate income at source except to the extent that the income arises from immobile rents like natural resources and some other location specific advantages. At base, as indicated, it is a tax competition story (Vann 2013 p64).

3.1. Source or residence based taxation of capital?

Australia, like most countries, levies CT on a 'source-country' basis, taxing the profits of all firms operating in the domestic economy regardless of their ownership. Most countries use source-based taxation and the residence country of the owner provides an exemption or foreign tax credit, so that Australian sourced income is not taxed again in the headquarters country of the multinational corporation. The US taxes the income of subsidiaries in Australia (and other countries) of US-based multinational corporations on the residence principle but only applies for profits remitted to the US, not retained in Australia and re-invested.

Under the source principle, the return to capital is taxed only in the country where it is invested. Source-based taxes may therefore be termed taxes on investment. Under the residence principle, the tax is levied only on the return to the capital owned by domestic residents, regardless of whether the wealth is invested at home or abroad. Since wealth is accumulated saving, residence-based taxes may also be termed taxes on saving.

The personal income tax as well as the personal wealth tax (where such still exists) are based on the residence principle, since domestic residents are liable to tax on their worldwide capital income and on wealth invested abroad as well as at home (Sorenson 2006 p173).

Adam et al (2013 p3) argue of the UK CT source basis that:

> *'…it attempts to tax profits derived from UK production, rather than, for example, profits from selling to UK customers (a 'destination basis') or profits of UK-owned companies (a 'residence basis'). The source basis is a problematic – arguably even incoherent –basis for taxation of multinational companies. Conceptually, there is*

often no right answer to the question of what shares of profits are generated by activities in different countries.'

One suggested solution is to reduce CT and rely more on the VAT/GST, which has a destination base and is in effect a cash-flow tax (Adam et al 2013 p4; Auerbach et al 2017).

It is hard to disagree with the conclusion of Sorenson and Johnson (2010 p190) that a source-based company income tax creates an incentive to shift taxable profits towards low-taxed foreign jurisdictions by manipulating transfer prices, royalties and internal interest costs:

'…there is ample empirical evidence... that the location of the taxable profits of multinationals is in fact quite responsive to statutory tax rate differentials [and in response to these practices] most OECD governments have introduced complex transfer pricing rules and thin capitalisation rules that significantly increase the cost of tax administration and compliance.'

As discussed above, these issues have led to major work on BEPS. Ideally, it would be better to have to rely less on administrative responses and more on structural changes to corporation tax which reduce these incentives.

The alternative approach is to concede that the CT system is not fixable and move to its gradual abolition.[15] This may appear a doctrine of despair, but in fact there may be good reasons why this is an optimal solution. If income derived in corporations was taxable to individuals in their country of residence, on the basis of the total of their domestic and foreign shareholdings, there would appear scope for tax simplification and a consistent treatment of capital incomes. However some theorists have questioned whether such a residence-based tax is administratively feasible, unless information sharing by national tax authorities becomes more prevalent. Otherwise tax can be evaded by using tax shelter countries and secret accounts.

Another issue is that residence taxes on individuals are not all that useful to countries with high proportions of foreign ownership, and for whom retention of source-based corporate taxation would appear to have advantages. While this is historically the situation in Australia, it is becoming less so over time since Australian corporations are more frequently investing overseas, reducing the net foreign investment share.

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[15] http://www.afr.com/news/policy/tax/scandals-could-lead-to-the-end-of-uk-corporation-tax-20151208-gli0yh. See also Cooper 2011 p8 and fn43, which references views about the demise of the corporation tax.

It has commonly been considered that it is not feasible to tax capital on a residence basis in a global context where capital is mobile, because residents can conceal their foreign source income from tax authorities absent general international information sharing (see e.g. De Mooij 2005, p283). However, the difficulties in taxing capital income on a residence basis may be less than the difficulties now encountered with the source basis for the CT and countries are, slowly, building coordination so as to identify and exchange information on individual income and assets (Stewart 2012).

It has been argued that CT taxes location–specific economic rents, such as the abnormal profits earned in the banking industry or which were being earned, until recently, in the resource sector.[16] However there are other ways to deal with these issues. For example the banking industry is being subjected to increased competition[17] and higher capital requirements, and there may be good arguments for resource rent taxes specific to the resource sector as a replacement for inefficient value or volume-based royalties.[18]

3.2. Options for capital income taxation

An alternative is to rely on capital income taxation of individuals which by definition includes income received via corporate structures. Under a comprehensive accruals income tax, companies and other business entities would not need to be taxed except in order to save on overall compliance or transactions-costs. That is, the undistributed income of a company would be automatically included in the income of its owners as an accrual. If companies are taxed, they are taxed effectively as agents for individuals. The tax on them is effectively a withholding tax on the investment income flowing to individuals (Wilson 2002 p4).

Liberal economists have tended to favour the Haig-Simons ideal of broad-based income taxation. However, that ideal does not require a corporation tax. In Blueprints for basic tax reform David Bradford sketched out both a consumption tax and a broad-based income tax model for fundamental reform, and neither included a tax on corporates (Edwards 2003 p30).

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[16] Sorensen and Johnson 2010 pp206-207; Stewart et al 2015 p64. If abnormal profits are only temporary, the issue arises as to whether they are really ‘rents’ at all.

[17] The new bank levy (a per centage of liabilities outside of government guaranteed deposits) is restricted to the ‘big 5’ banks and there is some, perhaps slight, hope that it will energise competition from outside the big 5.

[18] For a contrary view see Freebairn 2015b.

However there are two or three main issues which a CT appears to partly address. Edwards notes that under the Haig-Simons comprehensive income tax, *'business would not need to be taxed if all capital income were taxed on an accrual basis at the individual level. But that is extremely impractical… Instead the current income tax system settled on using corporations as 'pre-collectors' of income tax' (2003 p30).*

In our current system, capital gains benefit not only from the 50 per cent discount for assets held over one year, but also from tax deferral (Ingles 2009). There is the additional complication that capital gains tax may never be paid because there is in Australia no deemed realisation at death (unlike, for example, Canada). So CT acts as a form of source withholding for capital income that might not otherwise be collected. But the existing system of capital income taxation at the personal level is full of holes. In particular, the opportunity exists for wealthy investors to use corporations to lower their effective tax rate, since the CT under most realistic scenarios is likely to be less than the top marginal rate.[19] Investors can have the corporation earn income and re-invest it on their behalf, and it will emerge down the track as lightly taxed capital gains.

How important the withholding function of CT is depends on the general tax regime for capital income; there are options for personal taxation which might make it not important at all. This is particularly so of consumption tax options such as the cash-flow personal tax, but also true of intermediate options such as the *rate of return allowance (RRA)* and the cash-flow version of that, the *Z-tax* suggested by Ingles (2015). In short if we persist with a notional tax on income (Haig Simons) it may be convenient (but not essential) to tax corporations as a form of source withholding; if we were to shift to a different personal tax system this might not be necessary at all.

The Mirrlees Review noted that it may be administratively convenient to tax corporations rather than individuals so that CT may play an integral role in the effective administration of the personal tax system. *'For owner managers of small companies, we also have to consider the possibility that labour income can be disguised as capital income and appear in the form of company profits, dividends and capital gains'* (Mirrlees et al 2011 p409-410). However the CT rate of 30 per cent (20 per cent in the UK) is already well below the 50 per cent top marginal income tax rate, so CT does not appear to be a particularly effective response to this issue.

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[19] Although I note that there have been efforts to align the 2 rates in New Zealand.

As outlined earlier, there is significant foreign ownership (estimated at around 30 per cent) of corporations in Australia (and other places). There is an argument that we might not receive much direct financial benefit from foreign operations in Australia if they were not taxed. This argument is a two-edged sword. We receive a lot of other benefits from foreign investment apart from tax revenue, including employment, jobs and growth. On the MEB analysis summarised above, the effort to extract fiscal benefits cuts directly across what is needed for an economically efficient outcome.

The bottom line is that 'most countries tax corporate profit because most countries tax corporate profits' (Edward 2003 p31). Increasingly, that is becoming not a good enough reason.

4. Should we repeal the corporation tax?

Suggested options to repeal the CT often involve greater reliance on shareholder level taxes to make up the lost revenue. Many theorists see advantages in such a shift, although their proposals often involve something less than full repeal of the CT. One of the advantages is that for shareholder level taxes the tax burden appears to fall on capital, whereas for the CT the burden may well be on workers (e.g. Altshuler et al 2010 p357). These authors see such a shift as undoubtedly progressive.

The argument for abolition has been made by (Mankiw (2014), who notes that corporations are more like tax collectors than taxpayers as the burden is ultimately borne by people. There is debate in the literature about the economic incidence of the CT, with no general consensus (Freebairn 2015a p357). The Henry Review tended towards the view that in a small open economy most of the tax falls on labour (Treasury 2009). Freebairn suggests that 'at least 40 per cent, and as much as 60 per cent, of a reduction in the corporate tax rate would be distributed as higher labour income' (p367). Boadway and Tremblay (2014 p23) noted studies which suggested that between 49 and 77 per cent of the corporate tax burden is shifted to workers. Kouparitsas et al (2016), for the Treasury, find that the long-term benefits of CT cuts accrue to workers and households via permanently higher after-tax real wages and consumption.

By contrast to estimates of a high MEB for the CT, the MEB from likely alternative financing sources such as GST or income tax is estimated by Murphy at around 20-30 per cent (2016a Table 4.1). Note that the MEB of the CT will fall as the tax rate falls, implying that

reduction of rates rather than full abolition may be an optimal policy. However even at a 15 per cent CT the MEB estimated by Murphy is 68 cents (2016c Table A p6).

Mankiw suggests replacing the CT with a broad-based tax on consumption such as a VAT. This is consistent with a number of reform proposals in the US (although the VAT is re-labelled as the 'business activity tax' in one example). This could be supplemented by an income tax on high incomes (similar to Graetz 2007) or a wealth tax (Ingles 2016) and/or demogrants to help retain overall progressivity. Because a personal consumption tax allows indefinite deferral of tax (until consumption) there is no need for a corporation tax to buttress the tax base on an accruing basis.

In the US the corporation tax, despite the high headline rate, produces remarkably little revenue – only 1.8 per cent of GDP in 2013 – but has major compliance and collection costs. Altshuler et al (2010) model an increase in the US capital gains and dividend income tax, and find that taxing these as ordinary income allows the CT rate to reduce to 26 per cent and makes the tax system more progressive. Other US researchers have proposed reducing or abolishing the CT, financing this in part by accrual taxation of capital gains or its equivalent. Most researchers find benefits in shifting away from the CT towards greater levels of personal taxation.

Fehr et al (2013) simulate the complete abolition of the US CT, and find large gains:

> *'We find that eliminating the U.S. corporate income tax with no changes in the corporate tax rates of the other regions can produce rapid and dramatic increases in U.S. domestic investment, output, real wages, and national saving. These economic improvements expand the economy's tax base over time, producing additional revenues that make up for a significant share of the loss in receipts from the corporate tax' (2013, abstract).*

In their modelling, higher taxes on wages finance the tax change, but these can diminish over time. While the economic gains do not finance the change fully (i.e. there is no 'Laffer curve'), there is a Pareto improvement with no required additional compensation mechanism, due to the rise in wages. There are similar gains if consumption rather than wage taxes are used to offset revenue losses (Fehr et al 2013 p7).

This is the approach supported by FSC (2016) in Australia who suggests a 22 per cent corporate tax rate. KPMG (2016) modelling shows big long-run macroeconomic effects of

this package: GPD rises by 2 per cent in the long run[20] and investment is 4 per cent higher. Murphy (2016b) also concludes that 'the single most important tax reform for improving living standards is to reduce our reliance on company tax' (2016b p3), a result contested by Dixon and Nassios 2016, who by contrast see no net gain in economic welfare.

There is also what Boadway and Tremblay call the 'hold up problem', that governments will be tempted to hold on to capital taxes to exploit old capital. This 'constitutes a powerful political economy argument for taxing capital income or for taxing corporate income for that matter' (2014 p25). These authors also suggest about abolishing the corporate tax that: 'The same efficiency gains can be achieved without sacrificing all revenues by designing the corporate tax to be a tax on rents' (p47). However BEPS considerations make this conclusion arguable. Corporate rent taxes have a narrower base than corporate income taxes and for the same revenue require a higher rate.

4.1. Taxing capital income

As already noted, abolishing the CT would imply (in an income tax world) moving to residence-based taxation at the level of the individual investor. Such an approach has clear advantages in terms of conceptual clarity as it – in theory – removes thorny problems in defining 'source' or 'destination', as well as the integration issues that arise when the corporate income tax is interposed prior to levying an individual income tax. Toder (2016 p11) argues that '…it is better to base tax liability on the *residence of individual taxpayers* than on either the *tax residence of multinational corporations* or the *source of their profits*', since both of these two can be shifted in response to international tax differentials.

However Auerbach et al argue that *'in a globalized world, [the residence principle] is scarcely feasible, partly because tax authorities have no reliable way to get information about resident's foreign income'* (2010 p839; see also p880). This may be too pessimistic a conclusion; Piketty (2014) and Zucman (2014) have proposed ways to register foreign asset holdings and improve information sharing between national authorities.

For example, one way to tax corporate source income is through an internationally harmonised wealth tax as proposed by Piketty (2014) and discussed in Ingles (2016); this addresses the issue of income tax being deferred by re-investing within the corporation by

[20] Their proposal also involves personal tax cuts financed by the GST rise

in effect imputing an annual return. However Ingles notes drawbacks to the use of imputation or the annual wealth tax, as it penalises the less successful investor and rewards the more successful one – at least in the short run. (This has not stopped Australia using this principle extensively in the welfare system.)

Grubert and Altshuler (2015) would fund a halving in the US corporate tax rate (to 15 per cent) by taxing dividends and capital gains as ordinary income and by imposing an interest charge on deferred capital gains on corporate shares and all other assets. Also death would become a realisation event. Toder and Viard (2014) would abolish the CT and levy a tax on accruing capital gains; this proposal is designed to eliminate the benefits of tax deferral when retaining earnings within the corporation. For businesses that are not readily valued, such as non-publicly traded business, a flow-through basis would be used; this is meant to be equivalent to accrual taxation but is not deemed to be feasible for publicly traded business due to ownership turnover. A modified version of the Toder and Viard plan would see retention of a modest CT of 15 per cent and an imputation credit (Toder 2016 p12).The advantages of shareholder-level taxation have been discussed by a number of authors – see Grubert and Altshuler (2015 p27 and refs. therein).

Many of the issues for individual taxation stem from seeking an income tax base, and are substantially reduced if we adopt a consumption tax or cash-flow base for the individual tax.

For example, tax deferral within the corporation is not an issue if we convert the individual income tax to a cash-flow style of tax - Ingles 2015 notes several options. Ingles' Z-tax proposal, which is a sort of cash flow version of the RRA, accepts deferral until final consumption (as now occurs with capital gains taxes) as an integral part of the tax system, which moves the end result closer to an expenditure tax the longer the investment is held. It also allows for unlimited rollover within the Z-tax account, so that lock-in is not a major issue as it is with a conventional capital gains tax. Hence the Z-tax proposal as applied to individuals need not involve having a CT.

4.2. Recommendations of inquiries

In this Part, I briefly summarise the recommendations of various policy inquiries into tax reform including the corporate tax.

Treasury 2015 (Tax Discussion paper)

Treasury state that:

'While the legal incidence of corporate tax falls on companies, the economic burden of company tax is ultimately shared among its shareholders, consumers and employees. Empirical studies show that, in the long run, over half the economic burden of corporate tax is likely to be shifted way from shareholders through lower wages for employees and higher prices for consumers' (Treasury 2015 p78).

Burden shifting can occur because CT

'... reduces the level of investment in small, open, capital importing economies, such as Australia. This is because the marginal investor in Australia is likely to be a non-resident, who will invest in business opportunities in Australia only if they achieve an after-tax return that matches their target rate of return' (Treasury 2015 p78).

This of course is the source of the consensus estimate that the marginal excess burden (MEB) of the corporate tax is very high. For the Treasury, lowering the CT would provide an incentive for non-residents in invest in Australia and promote capital deepening, benefitting all Australians in the long run. Real wages would rise.

For multinational companies, a lower CT rate would reduce the incentive for tax planning and profit shifting from Australia. Lowering the CT rate would have a significant impact on tax revenues in the short term, although in the long term between 45 and 60 per cent of lost revenues might be made up in greater economic activity leading to higher revenues from other taxes (Treasury 2015 p80). There is also a cost offset from lower imputation benefits to individuals.

If CT is lowered, '*Australian investors would still pay tax at their marginal tax rate on company dividends through the imputation system and so would not benefit from a company tax cut to the same extent' (Treasury 2015 p80).* It follows that any company tax cut would be mainly about foreign investment, not domestic investment.

Australia already has some robust and sophisticated laws that deal with tax avoidance by multinational companies. These include comprehensive thin capitalisation rules, tough transfer pricing and controlled foreign company rules and an extensive general anti-avoidance rule (Treasury 2015 p82).[21]

[21] '*A comprehensive thin capitalisation regime aims to prevent excessive debt deductions by companies; tough transfer pricing legislation ensures cross-border related party payments are priced appropriately;*

However the effectiveness of such measures can be questioned, as big companies have the resources and the incentives to counter legislative crackdowns. Recent cases illustrate how complex these legal cases can become.[22] Nor is the ATO always the winner.

The Henry Tax Review 2009

Many of the ideas in Re:think are echoes of those in the Henry Tax Review (Treasury 2010a,b). That review argued for reducing the company tax rate to 25 per cent over the short to medium term. However, it also advocated increased resource taxation: '*Given company income tax also acts as a tax on profits derived from Australia's non-renewable resources, improved arrangements for charging for the use of these resources should be introduced at the same time' (ch5 p1).* The Government response to the Henry Report included a mineral resource super profit tax, the RSPT, which caused a huge push-back from the mining companies and was drastically modified under Gillard. As modified it raised almost no revenue and was abolished under Abbott. There were proposals to reduce the general company tax rate with proceeds from the RSPT, but these were never realised.

On dividend imputation, Henry argued:

> *'...as the Australian economy has become more open, the benefits of dividend imputation have declined…alternatives…should be considered.*
>
> *Such alternatives could include switching double tax relief from the shareholder to the company… Moving to a company or business level expenditure tax… would be another, more far-reaching option' (ch5 p2)... [we should] consider moving the company income tax system towards a business level expenditure tax, such as an allowance for corporate equity, subject to further international development of tax models' (ch5 p3-4).*

The case for these systems was outlined for the Review in the AFTS Conference Papers (Sorensen and Johnson 2010 and Auerbach 2010a). A business level expenditure tax such as the ACE was seen however as involving considerable risks.

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controlled foreign company rules aim to prevent Australian companies shifting income offshore; and an extensive general anti-avoidance rule aims to capture arrangements designed to avoid paying Australian tax.' Treasury 2015 fn. 87 p 82.

[22] 'Chevron loses long-running battle with ATO, faces multimillion-dollar tax bill': http://www.smh.com.au/business/the-economy/chevron-loses-longrunning-battle-with-ato-faces-multimilliondollar-tax-bill-20151023-gkgk6y.html#ixzz3rhd1G2cE, Sydney morning herald October 23, 2015 Nassim Khadem, Sarah Danckert,

The Mirrlees Review 2011

The UK Mirrlees Review reported in 2011. The Review concluded that while it makes sense to tax most business income before it leaves the company, the combined rates of corporate and shareholder taxation should equal the rates levied on employment and other sources of income. However the income definition should allow a deduction for the risk free component of the return at both the individual and corporate level, with a rate of return allowance - RRA - for saving and an allowance for corporate equity (ACE) at the corporate level. There should be full allowance for the latter when personal incomes are taxed. This would align tax treatment of employment, self-employment and corporate source income, making complex anti-avoidance provisions unnecessary.

The review conceded that the ACE system for the UK would have a significant revenue costs, but argued that if would be a mistake to recoup that by raising the corporate tax rate (Mirrlees et al 2012 p676).

In a Report for the Mirrlees review, Auerbach et al suggested that

> *'one might improve on Meade's proposed [cash flow] taxes by adding border adjustments; imports would be taxed, but tax on exports would be refunded. The result is a destination-based cash flow tax, essentially a destination-based VAT, but with labour costs deductible… We put forward a case for implementing a tax of this type on both real flows and financial flows…' (2010 p839).*

This approach was not adopted by Mirrlees but, as will be noted later, has been influential in the US CT debate.

The US President's Advisory Panel on Tax Reform (2005)

The US President's Advisory Panel (2005) considered two tax reform options. The first was an income tax approach which eliminated the double tax on corporate income by excluding most dividends and 75 per cent of capital gains from personal income. It also lowered the corporate tax rate to 31.5 per cent and simplified depreciation.

The second, the 'growth and investment tax plan', imposed a real cash-flow CT (R-CFCT) at a 30 per cent rate which combined expensing (immediate depreciation) of business investment and the equal treatment of debt and equity by denying deductions for interest. However for financial corporations, principal and interest paid would be deductible, and

principal and interest received taxable. (Financial corporations present special difficulties under an R-CFCT). This was to be combined with a 15 per cent flat rate tax on interest dividends and capital gains while retaining a progressive tax on labour income. Tax-exempt savings accounts would also be retained, making the system resemble, for many families, a consumption tax. The plan would be phased in over 5 years.[23]

The business tax would resemble a 'subtraction method' value-added tax, with the important difference that wages and other compensation would be a deductible expense. A third plan, the Progressive consumption tax plan, would not have taxed these capital sources at all, making it a pure consumption tax, but this was not agreed by the Panel.

Business tax working group 2012 (BTWG)

The BTWG was established in Australia to see if business could agree on a set of base-broadening measures which would finance a cut in the headline rate of company tax. The BTWG's Discussion Paper canvassed base broadening options in the areas of interest deductibility, capital allowances and R&D expenditure which, if adopted, could fund a company tax rate cut of 2-3 percentage points.

The Group reported in November 2012 but no agreement was reached. In particular there was a lack of support within the business community for this sort of package, which is unsurprising as the winners were balanced by losers. The group also considered the allowance for corporate equity (ACE) system and suggested that an ACE not be pursued in the short to medium term but may be a longer term option.

4.3. True profits base versus cash flow base (CFCT or CFT).

The 'true profits' base is the ideal under a system of comprehensive income taxation. However it is very hard to achieve in practice. As Meade (1978 p229) pointed out,

> *'It involves the deduction from gross profits of net interest on debt, an allowance for true economic depreciation adjusted for price inflation, a calculation of real accrued capital gains made by the company on its assets, and the adjustment for general price inflation of stock appreciation and of the value of monetary assets and liabilities… the effective implementation of such a tax presents many difficulties.'*

[23] This was not a pure CFCT since tax losses would not be refundable but would be carried forward indefinitely with interest.

If we wish to tax comprehensive income at the personal level, then the profits based corporate tax may be indicated at the company level since it allows a form of pre-payment of personal tax; by contrast if we wish to tax personal incomes on an expenditure tax base the cash-flow tax (CFCT) may be more appropriate, assuming we want a company tax at all. If we adopt a rate of return allowance (RRA) for personal taxation the suggested company tax is an allowance for corporate equity - ACE. However these are not hard and fast rules. In particular, if there is a full imputation system like Australia's, with refundability for low rate taxpayers, it doesn't matter much what the formal system of corporate tax is, at least as regards domestic taxpayers. Their ultimate tax liability is determined by the personal tax system so that errors in the calculation of 'true profit' at the corporate level wash out after the PIT is applied. The CT can be evaluated with reference to its impacts on foreign investment.

4.4. Capital gains tax reform and the Z-tax option

If the CT were to be reduced or removed the tax system may need to rely to a greater extent on capital income taxation so that corporate sourced income is taxed in one manner or another.[24] Dividend and interest income is not an issue, as it is fully taxable under the individual income tax (although interest income to foreigners is taxed relatively lightly with an average withholding rate of less than 5 per cent). Capital gains is a more serious issue, as the opportunity exists for income to be re-invested in the company or emerge, years down the track, not only as higher dividends but as capital gain. This is lightly taxed in Australia – as in most other countries – for 3 reasons

1. The capital gains tax is levied on only half the gain if the asset is held over 12 months
2. The tax is deferred, making the effective tax more akin to a cash-flow tax regime than an income tax regime. This lowers the effective tax rate on capital income, the more so the longer the period of deferral. However this sort of hybrid income-expenditure tax may be more efficient than a conventional income tax, for reasons set out in Ingles (2015).
3. There is no deemed realisation on death; assets are passed on to inheritors with an uplifted valuation base

It is possible but difficult to fix these problems within an income tax framework (Ingles 2009). For example:

[24] Some experts do not believe that capital income should be taxed at all. For a discussion (and rejection of this view), see Ingles 2015

4. Tax can be levied on accruals, as proposed in some of the US studies cited herein. This is conceptually the purest solution (but this is hard to apply to some assets, such as private companies), or by using a formula that compensates for tax deferral at the time tax is finally applied (e.g., Auerbach 2006 p416). This may be complicated and hard for taxpayers to understand.
5. The tax can be levied on the full gain (but the inflation adjustment to be restored) – this would be the same as the system that existed up until the Ralph Review (1999). This has been recently advocated by Fane and Richardson (2016) who noted in 2004 (p.220): '*the 1985-99 regime is clearly superior to the present regime under a wide range of alternative assumptions. Since the administrative costs of the 1985-99 and post-1999 CGT regimes are the same, there is no justification for the adoption of the economically inferior one'.*
6. Daley and Wood (2016) showed that a 25 per cent capital gains discount is approximately the same as full indexation under reasonable assumptions about inflation and likely real gains. However this is only true on average; the indexation approach is a fairer system for those earning at rates below or above the average. ALP policy is to halve the discount to 25 per cent.
7. The gains tax creates 'lock-in'[25] and this would be exacerbated by full taxation; this can be remedied by allowing rollovers (as are currently provided for in some small business concessions) but this defers revenue; lock-in is not necessary an issue for the revenue if one looks beyond current year accounting and take account of the fact that revenue is being deferred at the government's opportunity cost (the bond rate) and being added to at the average real capital gain in the economy – presumably a higher amount. However lock-in does have welfare costs for taxpayers.
8. Deemed realisation on death is easy in principle but in practice gives rise to political arguments about 'death taxes'.

Another approach to capital gains taxation is to use deeming or an annual wealth tax. These options – which amount to a presumptive taxation of capital incomes -are explored in Ingles 2016 and are currently used in the Netherlands 'box' system.

It may be preferable to address the issues in a non-income tax framework, such as an expenditure tax approach. Cash flow taxes on personal consumption are an option but have a number of disadvantages, the most notable being the almost complete exemption of capital incomes from tax.[26] To overcome such problems Ingles 2015 advocates a cash-flow approach called the 'Z-tax' (ZT) which can be designed to have a similar impact to the rate of return allowance (RRA) suggested by the Mirrlees Committee (2011). The ZT does not create 'lock-in' as it in effect allows for unlimited rollovers and deferral of tax – but not past the time of death.

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[25] Because of lock in the likely revenue from this change is not as high as the measured tax expenditure – see Evans et al 2015

[26] It is sometimes suggested that a cash flow tax taxes economic rents. In Ingles 2015 I question this.

At the individual level the ZT operates like a cash flow tax except that there is no rebate for savings. Instead, a tax credit is attached to the notional ZT 'box' (into which net savings are paid) which equals the tax paid on the amount saved and escalates annually by at least the inflation rate or the bond rate and is an offset to tax payable on drawdowns from the ZT 'box'. Inflows to the box add to the rebate; outflows from the box are taxed in full but tax is offset by the rebate which is paid out on a pro rata basis[27]. Transactions within the Z-tax box (including rollovers) are of no interest to the Tax Office, only net payments into it (which generate a notional rebate) and net payouts from it. The ZT thus puts all savings on the same tax deferred basis as capital gains, which is the source of its neutrality properties.

Both the RRA and the ZT are hybrid income-expenditure taxes but they are neutral (vertical) hybrids as opposed to the horizontal hybrid that now exists under the so-called 'income' tax. The ZT becomes more like an expenditure tax the longer assets are held, a result which would have pleased the Henry Review who were attracted to having lighter tax treatment of long term savings (due to intertemporal non-neutralities inherent in the income tax).

The ZT at the individual level is compatible with an income tax at the corporate level so long as there is full imputation. The economic incentives of this system are then determined by the personal tax - except for foreign corporates. The ZT is also compatible with a nil CT rate and in fact works well in such a regime as tax can be deferred either at the level of the corporation or by the individual and the effective tax rate on savings is independent of where that deferral takes place.

4.5. Corporate tax as part of the GST/VAT, and other options

There have been academic proposals for a cash-flow CT (CFCT) based on the destination principle. On option to implement this is via a higher VAT with allied reductions in wage taxes (Auerbach et al 2017). This is because a VAT is both a tax on consumption and also a tax on corporate rents (as well as consumption out of 'old' capital).

This VAT option has the advantage of building on an existing tax, and also of creating fewer problems for international tax treaties than the CFCT. However it is highly desirable that exemptions and zero ratings be abolished if the GST is to be used in this manner. Australia

[27] In proportion to the net asset in the box.

lacks broad-based wage taxes (which need to be reduced under this proposal) and there is an option to offset the impact of any GST rise with mechanisms such as universal cash payments – e.g., as envisaged under some forms of basic income.

Another option is to 'hollow out' the CT by gradually raising depreciation allowances above true economic depreciation rates. This has the advantage of reducing the marginal effective tax rates on new investment while preserving corporate taxation of 'old' capital. Ultimately this results in full expensing – i.e. 100 per cent depreciation allowances – and the end point is a CFCT, which has the effect of not taxing the normal return to capital but only economic rents. This has some advantages in terms of taxing the mining and banking sectors. To fully implement the CFCT further requires that interest not be deductible. However there are difficulties in taxing the financial sector under the R-CFCT; moreover there may be advantage in not moving to full expensing in one go but rather treating depreciation allowances as policy variable to influence the aggregate level of capital expenditure.

A third option is to lower the CT until its marginal excess burden is similar to that of other broad based taxes such as the GST or the income tax (this is the optimum configuration for all forms of taxation). This rate might need to be very low –possibly under 15 per cent. However this could still raise a meaningful amount of revenue, especially if it were allied with other base broadening approaches such as cessation of imputation and abolition of interest deductibility (as under the *comprehensive business income tax* or CBIT).

5. The future of corporate taxation

The corporate income tax is gradually going out of evolution. At one time it was a useful means of making the well-off pay at least some tax; new ideas in capital income taxation make it now less necessary (Ingles 2015 and 2016). It is also possible, as noted above, to reform capital gains taxation so that deferred incomes are fully taxed eventually. In the long run we can replace source-based corporate taxation, with all the difficulties that entails, with residence-based personal taxation with new, but hopefully more malleable, difficulties in discovering and assessing internationally-sourced income of domestic taxpayers.

As CT rates gradually fall around the world, Australia will need to follow these developments or risk becoming uncompetitive in our ability to attract footloose international capital, and in being able to retain accounting profits on-shore.

The CT was also a means of making foreign investors contribute to Australia's economic welfare. This argument has now become a two-edged sword, as it is now recognised that

there is limited utility to taxing foreigners given elastic supply curves and that the tax incidence may well fall – at least in part - on domestic wage earners, especially in the long run.

The corporate income tax is going out of evolution due to tax competition between countries, and while we should hold on to the corporate tax as long as possible, in the end we will need to ratchet the headline rate down in order to maintain relative competitiveness. It may be possible to finance this by base broadening and possibly the cessation of imputation, options canvassed in a separate paper. Ultimately we will probably end up with residence based taxation of individuals on their worldwide corporate source income, and this might not be a bad place to end up. But it might be a long time in coming, and we should cleave to some form of corporation taxation in the interim as the excess burden from the CT reduces rapidly as the rate reduces and the optimal rate will therefore remain positive so long as other competitor countries cleave to some form of corporate taxation.

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