

## B — Investment and entity taxation

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## B1. Company and other investment taxes

### Key points

Globalisation carries profound implications for Australia's tax system and for the taxation of investment in particular. In a world of increased capital mobility, company income tax and other taxes on investment have a major impact on decisions by businesses on where to invest, how much and what to invest in and where to record their profits.

Australia has been successful over recent decades in attracting foreign capital to finance relatively high levels of domestic investment. While the continuing growth of China and India, and the consequent strength in Australia's terms of trade, should ensure continued strong investment in Australia's resources sector, attracting investment in other sectors may become more challenging.

Reducing taxes on investment would increase Australia's attractiveness as a place to invest, particularly for foreign direct investment. Reducing taxes on investment, particularly company income tax, would also encourage innovation and entrepreneurial activity. Such reforms would boost national income by building a larger and more productive capital stock and by generating technology and knowledge spillovers that would improve the productivity of Australian businesses and employees.

Continuing to reduce biases in favour of particular assets by aiming for a broader, more uniform company income tax base would ensure that investment is allocated to its most productive uses. Reducing biases against risk-taking would also encourage entrepreneurial activity, which is important for economic growth. Features of the current system may bias investment and other business choices towards less productive outcomes. In turn, this may reduce productivity and economic growth.

For the longer term Australia should look more closely at moving to a business level expenditure tax. A few countries have adopted this alternative form of company income tax base in recent years, following widespread academic study. The Review has considered how Australia should respond to these policy developments. Adopting an expenditure tax base would change the dynamics of how Australia attracts international capital and overcome some of the problems of income taxes. However, it would inevitably give rise to other issues.

### B1-1 Costs and benefits of company and other investment taxes

Increased capital mobility over recent decades has focused attention on the effects of taxation on investment decisions. This trend is likely to continue, and while tax is only one of several factors that affect investment decisions, it is likely to be increasingly important.

Despite the increasing cross-border flows of capital, Australia will continue to exhibit some characteristics of a closed economy. Thus, the impact of investment taxes on economic outcomes in both open and closed economies needs to be carefully considered in the development of tax policy.

This section outlines broad principles that should be considered in relation to the taxation of investment and recommends some specific reforms and future directions. The related issue of the taxation of the savings of Australian residents is dealt with in Section A1 Personal income tax. How the taxation of companies and other business entities interacts with the personal income tax system, including the role of Australia's dividend imputation system, is dealt with in Section B2 The treatment of business entities and their owners.

## The role of company and other investment taxes

Australia's main investment tax is company income tax, which applies to the return to equity (retained earnings and capital contributed by shareholders) in companies. Company income tax can be seen as taxing the normal return to equity, as well as any above normal returns (or economic rents) generated by an investment.

Through dividend imputation, company income tax effectively acts as a withholding tax on company profits that represent a return to either the savings of Australian investors or the labour of owner-operators of businesses that operate through companies. Equity investments undertaken by unincorporated enterprises or individuals are typically financed from domestic savings, and taxed through the personal income tax system.

In the absence of a company income tax of some form, Australian residents who are shareholders in or owner-operators of companies could significantly reduce the personal income tax they pay by retaining income in companies. Company income tax therefore operates as an integrity (or backstop) measure for the personal income tax system to limit the deferral or avoidance of income tax.

For foreign equity investors in Australia, company income tax generally acts as a final tax, supplemented by dividend withholding tax on distributions paid to non-residents. In limited circumstances tax is also paid on capital gains, in the case of non-portfolio holdings in a 'land rich' company or on Australian sourced 'ordinary income'. Company level taxes are therefore the primary means of taxing foreign equity investments.

By contrast, the returns to debt in the form of interest are a deductible expense for a company or unincorporated business. Interest received by the lender is, however, taxed as income for Australian resident investors or by means of interest withholding tax for foreign investors.

### Principle

Company income tax is needed to raise revenue on the normal return, as well as economic rents, earned by foreign capital invested in Australia and to maintain the integrity of income tax as it applies to Australian residents.

## The economic impact of investment taxes

While the impact of the overall level of taxation on economic growth remains the subject of debate, there is reasonable evidence that the composition of taxes does affect growth. In particular, there is growing evidence that a shift away from company income tax towards greater reliance on taxing other less mobile factors of production, or on consumption, has the greatest potential to increase GDP and growth (see Part 1).

Income taxes on investment, specifically source-based taxes, can lead to lower domestic productivity by increasing the required pre-tax return from an investment (the cost of capital) and reducing the incentive to invest. This can result in a smaller domestic capital stock, which often leads to lower productivity and lower wages.

The impact of company income tax on capital accumulation depends on the openness of the economy. The more open the economy the more of an impact company income tax has on potential capital accumulation, as the level of capital investment is no longer constrained by the level of domestic savings.

Simulation analysis by Johansson et al. (2008) found that reducing the statutory company income tax rate from 35 per cent to 30 per cent would lead to an increase in the investment to capital ratio of around 1.9 per cent. The study found that the effect of company income taxes is strongest on industries that are older and more profitable (and so have larger tax bases). Younger and smaller businesses (such as start-ups) were found to be less affected, possibly because they are less profitable or because they benefit from concessional tax arrangements.

Johansson et al. (2008) also found that the positive impact of reductions in the company income tax rate diminishes as the tax rate is lowered. Countries with a relatively high company income tax rate are therefore likely to experience a larger positive effect from a given percentage point reduction in the tax rate than other countries.

In addition, where the income tax base differs from economic income, investment decisions may be biased towards less productive assets where concessions apply, or people may be discouraged from entrepreneurial activity. These distortions to the composition of investment can lower productivity.

Company income tax can affect productivity in a number of ways (Johansson et al. 2008).

- Where effective tax rates vary across assets, investment can be directed towards less productive uses.
- Through its effect in discouraging foreign direct investment, taxes on investment can adversely affect technology transfers and knowledge spillovers.
- Taxes on investment may also reduce investment in innovative activities, by reducing the after tax return.<sup>1</sup>

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<sup>1</sup> This can be exacerbated for more risky investments where the tax system places limitations on the use of losses.

- Complexity of the tax system can also reduce productivity by absorbing resources that could be reallocated to more productive uses. In addition, tax system complexity may also deter foreign direct investment.
- Company income tax can also distort financing decisions. This can affect productivity by distorting the allocation of investment across industries, favouring those sectors that can more easily access debt, relative to those that have to rely more on equity, such as those that invest more in intangibles.

Using firm level data, Johansson et al. (2008) found that over 10 years the effect of a reduction of the corporate tax rate from 35 per cent to 30 per cent would lead to an increase in the average yearly total factor productivity rate of 0.4 percentage points for firms in industries with median profitability. The analysis suggests that the negative effect of company taxes is uniform across firms of different size and age, except for firms that were both small and young.<sup>2</sup>

### How source-based taxes reduce investment

A small open economy, like Australia, does not have any noticeable impact on the international interest rate or the rate of return required by international investors. If the government imposes a source-based income tax, the pre-tax return to domestic investment will have to increase in order to generate the same post-tax return that could be earned by investing in another country with a lower tax rate.

As a result, some investments with a lower rate of return will not be undertaken, domestic investment will fall and less capital will flow into the country. This will continue until the pre-tax return has risen sufficiently to compensate investors for the effect of the source-based tax.

There is substantial econometric evidence that company income taxes affect foreign direct investment. A review of a wide range of empirical estimates concluded that a one percentage point increase in the marginal effective tax rate causes a 4 per cent fall in the stock of inbound foreign direct investment (de Mooij & Ederveen 2008).

Other studies have also suggested that foreign direct investment may be more responsive to changes in the tax rate as the gap between a country's tax rate and those of other countries increases. For example, foreign investment may be more sensitive to tax where the country's tax rate is significantly above average (Bénassy-Quéré et al. 2003).

### Who carries the burden of company income tax?

At first it may appear that the burden of company income tax effectively falls on shareholders, who receive a lower post-tax return on their investment. But this view ignores the possibility that the tax could be shifted to consumers through higher prices, workers through lower wages, or other types of capital through lower returns as capital shifts out of the corporate sector in response to the lower post-tax return from corporate equity.

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2 The results refer to a sample of firms extracted from the Amadeus (Bureau van Dijk) database (covering European OECD member countries) and the Worldscope (Thomson Financial) database (covering non-European OECD countries).

In a small open economy with perfect capital mobility, the burden or incidence of a source-based tax is shifted onto labour and land. As the source-based tax applies only to domestic investment, foreign investors can avoid the tax by moving their capital offshore. If a source-based tax is imposed or increased, capital flows out of the country until the pre-tax return increases by the full amount of the extra tax. This leads to less capital in the economy, less machinery, plant and research and development per worker and per hectare and therefore lower productivity of labour and land. In turn this means lower wages for workers and lower rents for the owners of land. In this simple model the burden of the source-based tax is fully shifted onto less mobile local factors of production.

Furthermore, because productivity is reduced, the tax burden on less mobile factors may be greater than the tax revenue collected. The obvious conclusion of this is that, given certain stringent assumptions, a small open economy should not levy source-based capital income taxes because they reduce national income (Gordon 1986).

While there is general agreement that at least some of the burden of company income tax is shifted onto labour, the extent of this is less clear. Economies are not fully open and capital is not perfectly mobile. Hence, the short-run and long-run effects are likely to differ. The US Congressional Budget Office (1996) has drawn some general conclusions from a survey of the literature:

- In the short-term, the burden of company income tax probably falls on shareholders or investors in general, but because investments are taxed differently, it may fall on some more than others.
- In the long-term, the burden of company income tax is unlikely to fall fully on corporate equity. This is because the company income tax is likely to affect investment decisions.
- In the very long-term, the burden of company income tax is likely to be shifted in part to labour, if the corporate tax dampens capital accumulation.

Hassett and Mathur (2006) find that a 1 per cent increase in the corporate tax rate is associated with a close to one per cent drop in wage rates. Felix (2007) estimates that a 10 percentage point increase in the corporate tax rate reduces annual gross wages by 7 per cent. Arulampalam, Devereux and Maffini (2009) estimate that around 75 per cent of any increase in source-based taxes on corporate income is passed onto workers in lower wages in the long run.

While these econometric findings are not without their limitations, they are broadly in line with the estimates derived from the use of computable general equilibrium models.<sup>3</sup>

### Principle

In setting the company income tax rate and base, consideration should be given to its real incidence on shareholders, workers, land owners and other capital owners.

There is no 'fair' share of company income tax in isolation of these effects on individuals.

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<sup>3</sup> Gentry (2007) provides a comprehensive discussion of these and related studies on the incidence of the company income tax.

## The taxation of economic rents

The analysis of where the incidence of company income tax falls is based on investments earning the normal return, or the going market return on capital. But many investments earn economic rents; that is, profits in excess of a market return. For debt, the normal return is the market rate of interest on debt for the relevant risk class. For equity, the normal return is the required market rate of return on stocks with the relevant risk characteristics.

In a closed economy, taxing the normal return will reduce the level of saving and therefore investment; however, a tax on economic rents would not normally bias investment decisions.

In an open economy, the impact of a tax on economic rents will depend on the mobility of the rent. Economic rents can be characterised as either firm-specific (or mobile) or location-specific. Investment generating mobile rents (arising from factors such as management know-how, a brand or a businesses' possession of a particular technology) can be moved from one jurisdiction to another. Location-specific rents may arise from exploitation of natural resources, existing fixed investments (such as factories), agglomeration (where businesses obtain benefits from co-location such as economies of scale), attractive local infrastructure, public services and institutions or consumer preference for domestically produced over imported goods.

For a mobile rent, source-based taxes can reduce investment. Investors will simply shift the investment to a lower tax jurisdiction so they can receive a greater share of the rent. In contrast, a source-based tax on a location-specific rent will not distort investment decisions.

## Source-based taxes and profit-shifting

A high rate of source-based company income tax relative to other countries — including a tax on economic rents — creates an incentive for multinational groups to shift taxable profits from Australia to low-tax foreign jurisdictions.

In the absence of anti-abuse provisions, this can be done by shifting debt and the associated deductible interest payments and other expenses including management and intellectual property costs from foreign affiliates to Australian members of the multinational group (thin capitalisation) and by manipulating transfer prices and royalties for intra-group transactions. For example, a foreign company that purchases goods from an Australian subsidiary for much less than the goods are worth would reduce the subsidiary's taxable income.

Most advanced countries have specific rules to prevent or limit transfer pricing and thin capitalisation, which, while increasing the costs of tax administration and compliance, are an important means of defending source-based investment taxes. Withholding taxes can also tax profits shifted through interest payments or as royalties, although typically at lower rates than the company income tax rate.

Despite these rules, there is ample international empirical evidence that multinationals are able to shift at least part of their profits to countries with low statutory tax rates (de Mooij & Ederveen 2008). The possibility of international profit-shifting therefore remains an important constraint on tax policy in an open economy.

Australia's dividend imputation system may reduce the incentive for Australian multinationals with a large domestic shareholder base to shift profits offshore, because these companies have an incentive to pay tax in Australia in order to pay fully franked dividends.

### Why retain source-based taxation?

The analysis of the costs and benefits of source-based taxation suggests that small open economies, such as Australia, should not levy source-based capital taxes. However, in practice, despite the trend towards lower company income tax rates, they are far from zero. There are a number of reasons for retaining source-based capital taxes, and the company income tax in particular.

First, the argument that small open economies should not impose source-based taxes relates to taxing the normal return to capital. As previously discussed, where an investment generates a location-specific rent, the rent can be taxed without deterring the investment, making it a relatively efficient tax base. As a resource rich country with a well-educated workforce, effective regulatory regimes and a relatively large existing capital stock, Australia has substantial location-specific rents. Australia's geographic isolation may also give rise to some economic rents due to high transportation costs, while limiting the scope for others (such as those derived from economies of scale associated with serving large markets). Rents may also arise from preferences for Australian products that are differentiated from imported imperfect substitutes.

Second, although the international mobility of capital has grown, capital is still not perfectly mobile. This is particularly true of equity markets. Investor portfolios are still biased towards domestic assets, perhaps because investors are less familiar with foreign financial markets, have less control over foreign investments and would need to manage foreign exchange risks. Firms often face significant adjustment costs if they want to relocate business investment across borders. These factors allow governments some scope for imposing source-based investment taxes without causing significant capital flight.

Third, source-based capital taxes may also be justified on the basis of the 'treasury transfer' effect. For example, a foreign country taxes its residents on their global income may provide a credit for source-based taxes paid in Australia. A reduction in Australian company income tax would result in a lower foreign tax credit in the country of residence, leaving the foreign investor's worldwide tax liability unchanged. A reduction in Australian tax therefore results in revenue shifting from Australia to the other country with no increase in the level of investment in Australia.

The extent to which the treasury transfer effect applies in practice is unclear. Most countries are moving away from worldwide income taxation. For example, the United Kingdom and Japan, which previously practised worldwide taxation, have recently moved to dividend exemption systems. This means that most income from equity investments in Australia is exempt from tax. However, the United States, which has around 23 per cent of foreign direct investment in Australia, still has worldwide taxation. But even for countries that still tax worldwide income, the ability to avoid or defer taxation can reduce the value of credits and may limit the extent of the treasury transfer effect.

As discussed previously, the company income tax also operates as an integrity (or backstop) measure for the personal income tax system.

### Principle

In setting the effective company income tax rate, a balance needs to be struck between:

- the benefits of a lower rate in attracting internationally mobile investments or capital; and
- the benefits of a higher rate in reducing opportunities for domestic residents to defer or otherwise reduce tax on their personal income, and in taxing the returns to less mobile investments or capital.

## Targeted responses to international tax competition

The previous section suggested that there is a case for taxing different types of investments at different rates depending on their international mobility.

Many countries tax investments according to their mobility. For example, resources, which generate location-specific rents, are typically taxed at higher rates, while more mobile investments such as research and development are often concessionally taxed. In Ireland, the manufacturing and traded services sectors are subject to a preferential corporate profit tax rate, while developing countries often use tax holidays to attract international investment, and many countries have adopted tonnage taxes for international shipping.

The most effective tax instrument for attracting investments generating economic rents that are also highly mobile is a reduction in the tax rate. This would reduce the amount of tax applying to the firm-specific economic rent that the investment generates. However, reducing income tax rates for particular investments would also reduce tax on the normal return to those investments relative to other investments, potentially distorting investment allocation.

An alternative approach is to allow eligible investments to be written-off at an accelerated rate. This reduces the tax on the normal return to the investment as opposed to the firm-specific rent, and so is likely to have greater downside costs due to inefficient allocation of investment and the potential for also distorting production decisions within a sector.

Another problem with targeted tax concessions is the difficulty of determining which sectors or investments they should apply to, particularly in terms of identifying activities or sectors with significant firm-specific rents. Where tax concessions are inappropriately targeted they will further adversely distort resource allocation. As such, the use of targeted provisions needs to be based on strong supporting evidence and must be balanced against the distortions they create to investment allocation and the additional compliance and administration costs.

### Principle

Differential tax arrangements for particular sectors or types of investment, as a response to international tax competition, should not be adopted given the potential effects on resource allocation, except in limited circumstances where there is strong evidence to support their use.

## International tax coordination

Early efforts at international tax coordination centred on eliminating the double taxation of cross-border investments. Bilateral tax treaties became the primary means of reducing the risk of double taxation, and of reducing other tax barriers to cross-border investment such as tax discrimination and compliance costs.

The focus of international tax coordination has now changed. Concerns now centre on the potential impacts of international tax competition and a ‘race to the bottom’ in company and capital income tax rates, in the face of a worldwide decline in company income tax rates in recent decades and the potential for international tax evasion.

Competing reductions in source-based capital taxes may arise because the supply of capital to an individual country is more responsive to taxation than the global supply of capital. From a global perspective, however, the consequence of individual countries’ decisions to reduce capital income taxes may be an inefficiently low level of capital taxation that limits their ability to finance public services and undertake redistribution.

This characterisation of the effects of international tax competition is not, however, universally accepted. International tax competition is one of the many brakes on increasing taxes, and some argue that this limits the over-expansion of government. There may also be countervailing factors that limit company income tax rate reductions. For example, as economies become more open and the proportion of domestic companies owned by non-residents increases, governments may have an incentive to raise company income taxes on the basis that this exports, or at least appears to, part of the tax burden to foreign investors.

A radical form of international tax coordination would see countries relinquishing source taxation altogether and only imposing residence-based taxes. However, the constraints on national sovereignty implied by such an approach make it highly unrealistic. An alternative approach would be to permit countries to retain source-based taxation but on a harmonised basis. Tax harmonisation of company income taxes has been discussed within the European Union for a number of years, although with little apparent progress to date.

Estimating the potential benefits or costs from international tax coordination is challenging. Standard tax competition models, which assume a large number of small, homogeneous countries, fixed national populations with identical tastes and preferences, and perfectly mobile capital flows, predict that all countries will unambiguously benefit from tax harmonisation (Zodrow 2003). However, these results are challenged by other models.

For example, the ‘new economy geography’ model considers the case where there are two types of countries: those with agglomeration rents (typically large) that can support high levels of investment taxation and provide high levels of public service as desired by their citizens; and smaller, low-taxing countries that do not have these agglomeration rents. In this model, tax harmonisation is not beneficial. It reduces the ability of smaller countries to compete for mobile capital and the ability of larger countries to provide the level of public services desired by their citizens (Zodrow 2003).

Attempts have been made to estimate the impacts of tax harmonisation within a region, in particular Europe. Harmonisation within Europe has been estimated to lead to a modest increase in *total* welfare, with an increase in GDP of around 0.1 to 0.4 per cent. However,

these benefits are estimated to be unevenly distributed between individual countries, with losers as well as winners (Griffith, Hines & Sørensen 2009). The likely divergence in outcomes, and the fact that the winners are typically those countries that achieve harmonisation by reducing tax rates and revenues (making compensating transfers problematic), suggest the potential for tax harmonisation is limited on a worldwide basis.

Harmonising worldwide investment tax bases and rates may therefore be an unrealistic goal, even if it is of potential benefit to Australia (which is unclear). But given the potential costs of a worldwide trend to very low company income tax rates, Australia should not aim to radically cut its company income tax rate ahead of other countries. Furthermore, as discussed previously, the lower the existing company income tax rate and closer it is to that of other countries, the lower the likely benefit from additional reductions.

Reflecting the difficulties and uncertain benefits of deeper forms of tax coordination, recent global developments have largely had more limited objectives. These have included shoring up countries' abilities to impose residence taxation by improving the exchange of information between tax administrations. This more limited approach permits countries to craft their individual tax systems to reflect differences in factor endowments and productivities, and national preferences towards redistribution.

The global economic crisis has led to unprecedented action to improve international standards of transparency and information exchange. This work is undertaken through the Global Forum on Transparency and Exchange of Information, which Australia currently chairs. Since April 2009, more than 90 tax information exchange agreements have been signed and over 60 tax treaties have been negotiated or renegotiated to reflect improved standards on transparency and exchange of information.

Australia's tax treaties provide for exchange of information, and to date Australia has entered into nine tax information exchange agreements with several more being negotiated.

### Principles

Australia should not be at the forefront of any 'race to the bottom' in company income tax rates.

International tax coordination is required to support cross-border income taxation, particularly the effective exchange of information to allow for the enforcement of taxes on the savings income of residents.

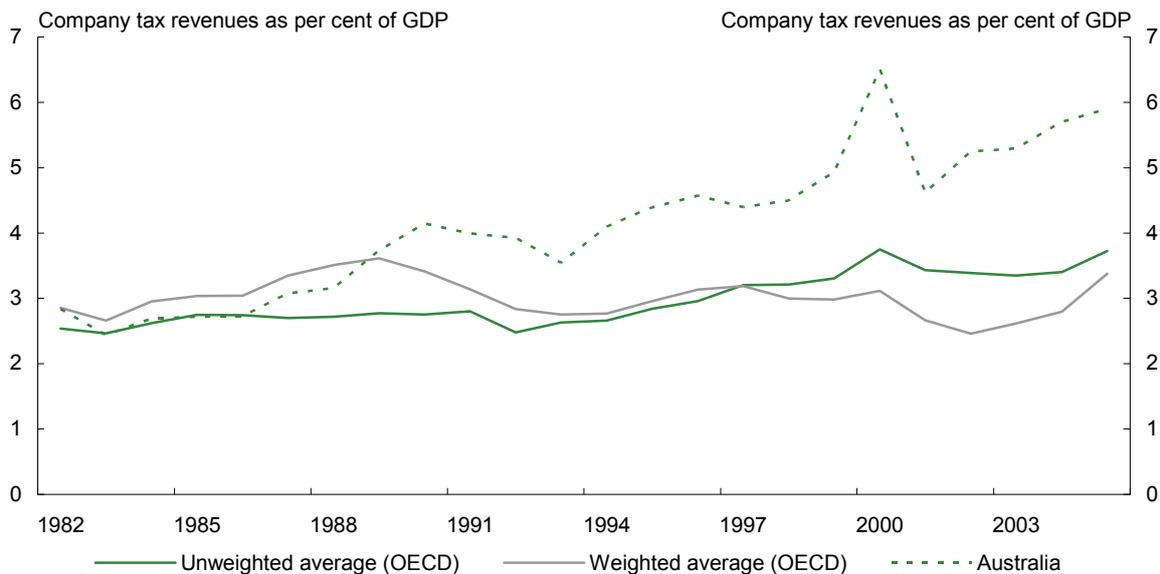
## B1-2 Australia relies heavily on company income tax

At the international level, Australia's tax system stands out for its relatively high reliance on company income tax.

From 1982 to 2007, the OECD average (unweighted) corporate tax to GDP ratio increased from around 2.5 per cent to 3.7 per cent (see Chart B1-1). This increase may reflect a number of factors, including increasing profitability and structural changes (for example, a decline in the agricultural sector and an increase in the finance sector's share of the economy).

The increase in the corporate tax to GDP ratio has been more pronounced in Australia. After following the average OECD trend in the early 1980s, the company income tax to GDP ratio increased from around 2.7 per cent in 1985 to 5.9 per cent in 2005. Many of the explanations applying to other countries are also likely to explain the growth in the company income tax to GDP ratio for Australia. For example, the factor share of the corporate sector (the ratio of GOS to GDP) increased from 16.6 per cent in 1980–81 to 23.9 per cent in 2005–06 (Clark, Pridmore & Stoney 2007).

**Chart B1–1: Corporate tax revenues in the OECD 1982–2005**



Source: Loretz (2008), with additional data from author.

Australia's company income tax revenue as a proportion of GDP (5.9 per cent) is the fourth highest in the OECD and much higher than the OECD average (3.7 per cent). This reflects a number of factors including:

- Australia's company income tax revenue, as measured for these purposes, includes taxes on superannuation funds levied on contributions and earnings (which are effectively taxes on individuals' savings) and petroleum resource rent tax revenue.
- Levels of incorporation differ across countries, and the classification of income from companies may differ. For example, tax revenue from 'S corporations' in the United States appears as a tax on individuals.
- Levels of corporate sector profitability differ across countries. For example, the profitability of Australia's corporate sector is typically high because it includes economic rents arising from Australia's natural resources.
- There may also be an incentive for domestically-owned companies to pay tax in Australia in order to pay fully franked dividends under Australia's imputation system (see Section B2 The treatment of business entities and their owners).
- Australia has a relatively broad based company income tax, with limited concessional write-off arrangements compared to many OECD countries.

**Finding**

Australia has a relatively high reliance on company income tax compared to other OECD economies. This reflects, in part, classification differences in disaggregating company income taxes and Australia's abundance of natural resources, a high level of incorporation, the corporate sector's high level of profitability, the dividend imputation system, and a relatively broad company income tax base.

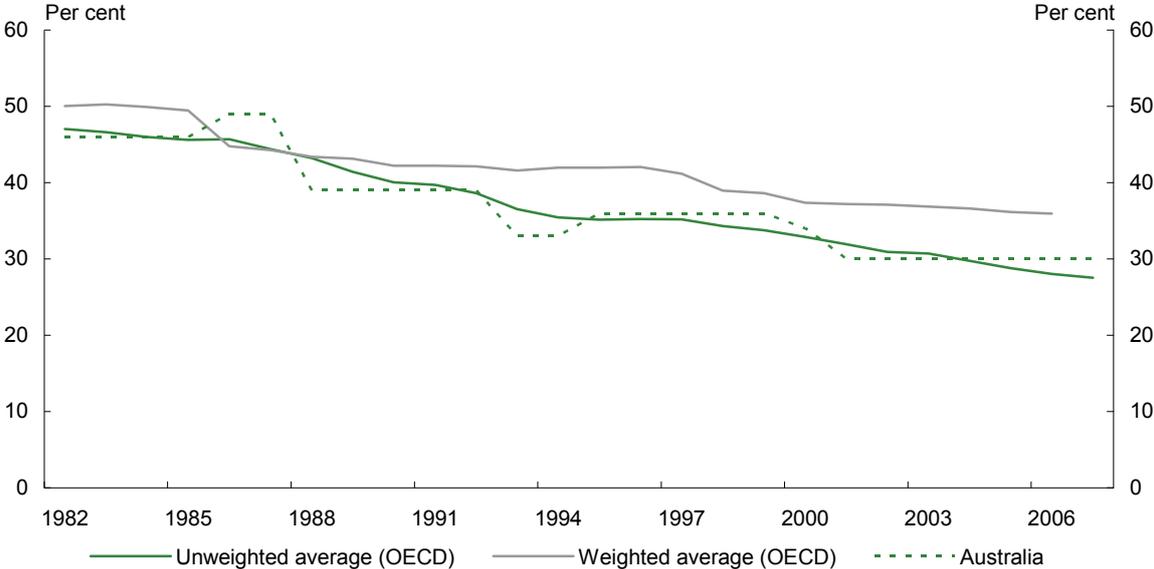
**Company income tax rates have been falling worldwide**

Company income tax rates have fallen across the OECD over the past 30 years (Chart B1-2). The fall in the average statutory corporate tax rate across the OECD has been fairly continuous. The unweighted average company income tax rate fell from around 47 per cent in 1982 to around 28 per cent in 2007. The weighted average (which is heavily influenced by the United States, Japan and the United Kingdom) has fallen to a lesser extent, from around 50 per cent in 1982 to 36 per cent in 2006.

The unweighted average tax rate has been falling faster than the weighted average because smaller economies have been reducing rates faster than larger economies. This is unsurprising as larger economies such as the United States have more scope to set their corporate tax rate based on domestic considerations.

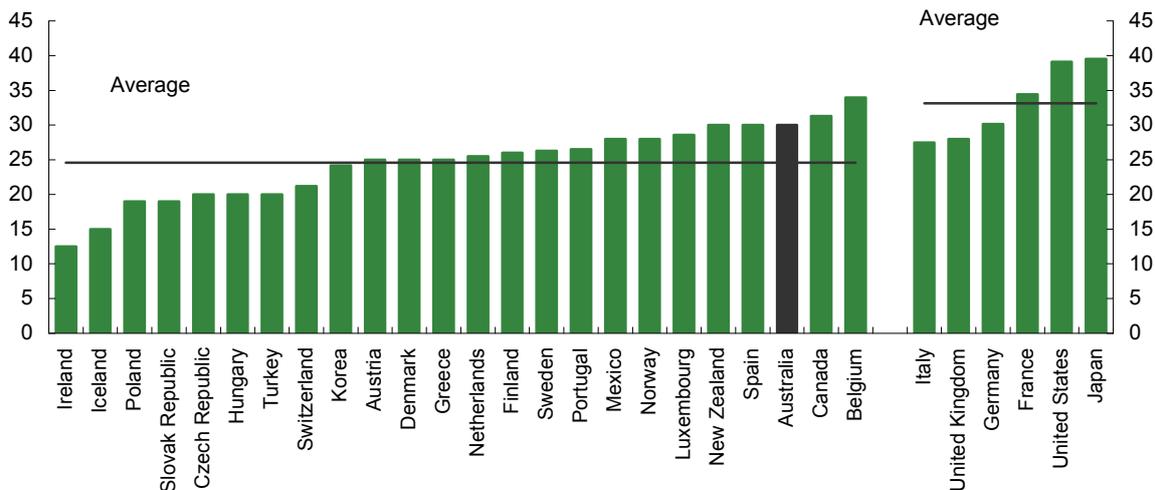
Australia has, until recently, followed this trend, with the company income tax rate falling from 49 per cent in the mid-1980s to its current rate of 30 per cent in 2001.

**Chart B1-2: Statutory corporate tax rates in the OECD 1982-2007**



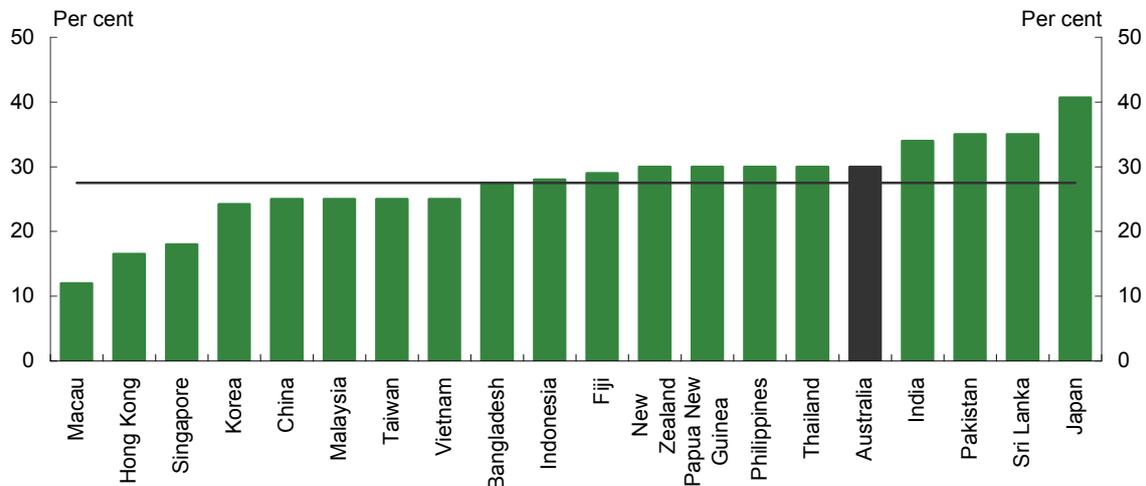
Source: Loretz (2008), with additional data from author.

Unlike Australia's company income tax rate, the unweighted average rate has continued to fall. In 2001, when Australia reduced its statutory company income tax rate to 30 per cent, it had the ninth lowest rate in the OECD. Australia now has one of the highest corporate rates among small to medium OECD countries, and at 30 per cent is well above the average for small to medium OECD countries (around 25 per cent) (see Chart B1-3).

**Chart B1–3: Statutory corporate tax rates, OECD countries 2009**

Source: OECD (2009d).

Australia's company income tax rate is also relatively high compared to other countries in our region (see Chart B1–4). Australia's current company income tax rate is significantly higher than Hong Kong (16.5 per cent) and Singapore (18 per cent) and marginally higher than the average for the Asia-Pacific region (27.5 per cent).

**Chart B1–4: Statutory company income tax rates, Asia-Pacific countries 2009**

Source: KPMG (2009).

While reductions in company income tax rates have been characterised as a 'race to the bottom' among OECD countries, reforms to company income tax have often also involved structural improvements to those tax systems.

For example, the decline in statutory company income tax rates across the OECD over the past 30 years has been accompanied by a broadening of the company income tax base. Australia has followed this trend, most notably by including capital gains (1985–86) and income from the life insurance and gold mining industries (1990–91). At the same time, Australia abolished the general investment allowance (1988–89) and the accelerated depreciation regime (1999–2000).

If reducing rates and broadening bases has reached or is reaching a natural limit, further rate reductions would have a significant cost. While this raises some uncertainty over the likely future path of company income tax rates internationally, it could be expected that continued pressure to attract mobile capital will lead to further reductions in rates over the longer-term.

That said, given the fiscal pressures arising in most developed countries from the global financial crisis, the ability for many countries to significantly reduce their company income tax rate may be limited, at least in the medium term.

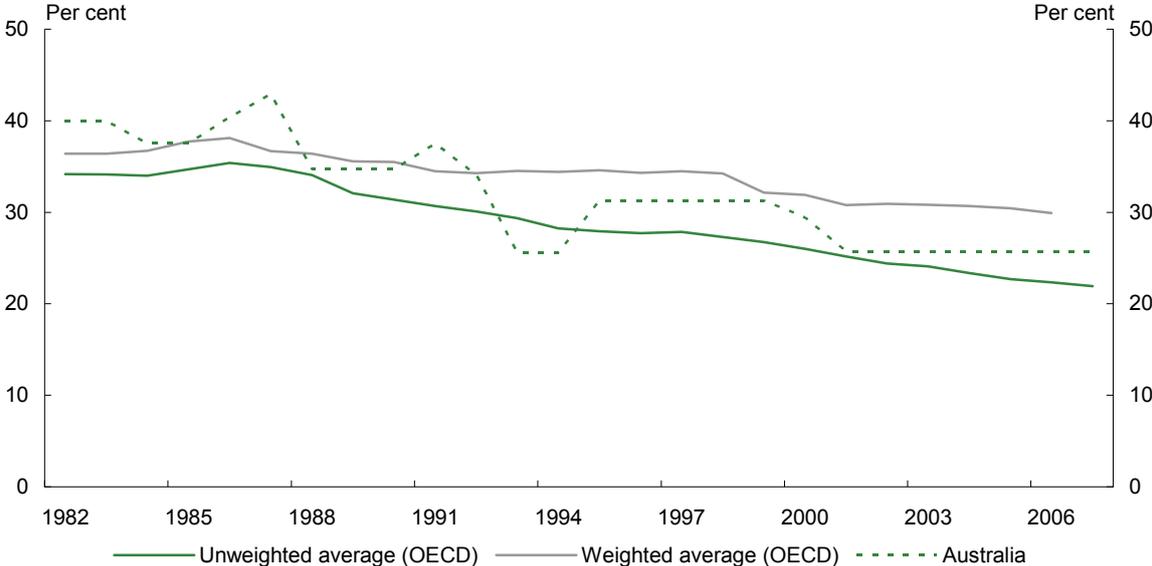
**Effective company income tax rates have also been falling**

While base broadening has, to some degree, offset the cuts in statutory corporate income tax rates, measures of the effective marginal tax rate and effective average tax rates, which take into account the statutory rate as well as elements of the tax base for a hypothetical project, have declined.<sup>4</sup>

Charts B1-5 and B1-6 present the trends in effective marginal tax rates and effective average tax rates respectively. Both measures have followed a similar downward trend, suggesting the broadening of the tax base did not fully offset the fall in statutory tax rates. The fall in effective marginal tax rates is less pronounced than the fall in statutory rates and effective average tax rates, indicating that countries may have reduced effective average tax rates to attract more profitable businesses (Devereux et al. 2002).

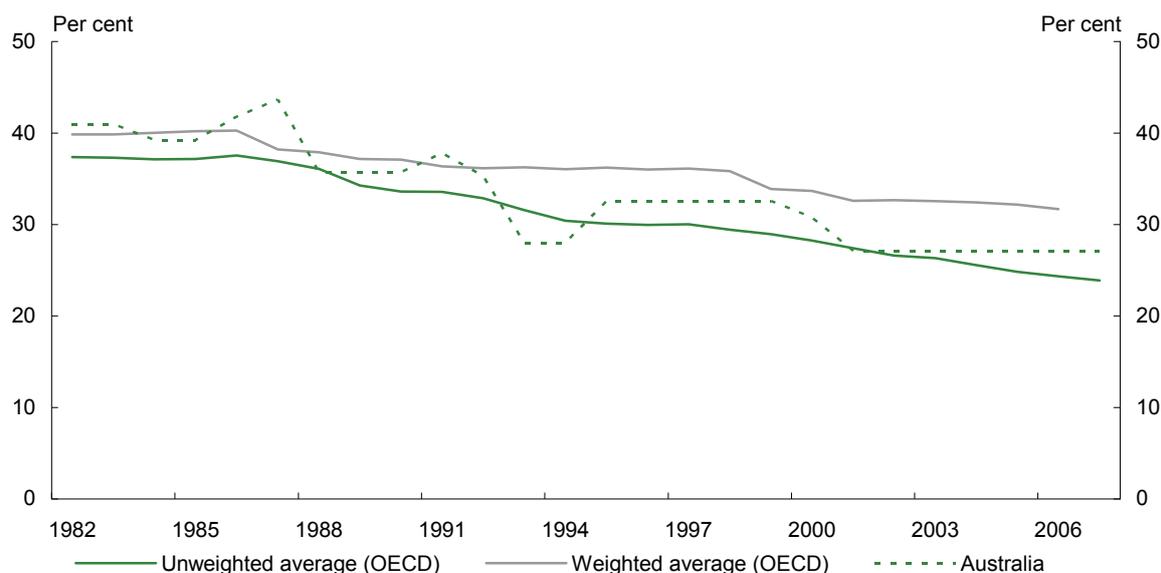
Australia has followed this trend with both marginal and average effective tax rates falling over the past 25 years.

**Chart B1-5: Effective marginal tax rates in the OECD 1982-2007**



Source: Loretz (2008), with additional data from author.

4 The effective marginal tax rate measures the tax burden on an investment just earning the same return as an alternative investment; the effective average tax rate measures the tax burden for an inframarginal investment with an economic rent.

**Chart B1–6: Effective average tax rates in the OECD 1982–2007**

Source: Loretz (2008), with additional data from author.

### Finding

Australia's company income tax rate, which currently stands at 30 per cent, is high relative to other comparably sized OECD countries. The average rate for small to medium OECD economies is currently around 25 per cent.

## B1–3 The future of company income taxation

### Longer term options

The increasing globalisation of the Australian economy raises questions about the appropriateness of the existing company income tax system and the dividend imputation system.

In this light, a number of options were considered for the fundamental reform of the company income tax system. These options, which have received widespread attention in the international tax policy debate, particularly in recent years,<sup>5</sup> can be characterised by the location of the tax base, and the type of income subject to tax (see Table B1–1).

There are three possible locations of the tax base:

- income from where the investment takes place (source-based taxation);
- income, wherever earned, of a company resident in a country (residence-based taxation); and
- the sales (net of costs) in the country where the goods or services are consumed (destination-based taxation).

<sup>5</sup> See, for example, the Mirrlees Review ([www.ifs.org.uk/mirrleesreview](http://www.ifs.org.uk/mirrleesreview)).

There are also three types of income that can be subject to tax:

- the full return to all capital (equity and debt);
- the full return to equity; and
- economic rents.

**Table B1–1: Alternative options for taxing company income**

Location of base	Type of income subject to tax		
	Full return to capital	Full return to equity	Economic rent
Source country	Comprehensive business income tax	Conventional corporate income tax with exemption for foreign source income	Source-based business expenditure tax (such as an allowance for corporate equity or capital and source-based cash flow tax)
Residence country		Conventional corporate income tax with credit for foreign taxes	
Destination country			Destination-based business expenditure tax (such as a full destination-based cash flow tax and a VAT-type cash flow tax)

Source: Based on Devereux and Sørensen (2006).

The existing company income tax is essentially a source-based tax on the full nominal return to equity.<sup>6</sup> As noted previously, there is a case for small open economies, such as Australia, to reduce source-based taxes on the normal return. Of the remaining options, the comprehensive business income tax taxes the full return to capital (debt and equity), albeit at a possibly low marginal rate, and the various forms of business expenditure tax exempt the normal return from tax, only taxing economic rents.

The comprehensive business income tax is based on an income tax system, but with the difference that interest expenses would no longer be deductible. Removing the deductibility of interest removes the distortion between debt and equity. The broadening of the tax base could facilitate a reduction in the company income tax rate, but this would reduce its effectiveness as a backstop to the personal income tax system. As a significant amount of debt is currently untaxed, this option would also increase the cost of debt financed investment. There would also be significant transitional issues for highly leveraged businesses.

Business level expenditure taxes can be imposed on either a source or destination basis. A source-based tax, such as an allowance for corporate equity or allowance for corporate capital, would tax all economic rents generated in the country where the investment takes place. Under a destination-based tax, only economic rents used for consumption in the domestic economy would be subject to tax.

Business level expenditure taxes also provide greater neutrality between debt and equity. In addition, these systems also reduce pressure around the timing and recognition of income and expenses. For example, under an allowance for corporate equity the timing of capital allowances becomes less important. Such systems are also neutral in relation to the effects of inflation. In effect, such systems would reduce distortions across asset types which could

<sup>6</sup> Australian resident companies are technically taxed on their worldwide income with an exemption for profits from permanent establishments and non-portfolio foreign dividends.

assist in promoting efficient resource allocation and may also provide opportunities for further simplification of the company income tax system. The case for these systems has been outlined for the Review by Auerbach (2010) and Sørensen & Johnson (2010).

A resource rent tax based on an allowance for corporate capital model is recommended for the taxation of resource rents (see Section C1 Charging for non-renewable resources).

However, in contemplating the replacement of company income tax with an expenditure tax, a significant concern for the Review is that there has been limited or no practical use of such taxes for this purpose.<sup>7</sup> Replacing the current company income tax system with one of these alternatives would therefore involve considerable risks. For example, the practical implications from a tax administration and compliance perspective are unknown. From an international context there may also be opportunities for tax arbitrage if Australia is one of only a few countries using a system.

On balance it is therefore recommended that Australia maintains the existing company income tax system, at least in the short to medium term.

For the longer term, a continuing trend of increased openness and greater capital mobility suggests consideration needs to be given to eventually moving away from the dividend imputation system as a means of integrating the personal and company income tax systems. A business level expenditure tax would provide an alternative means of integration, though not the only one (see Section B2 The treatment of business entities and their owners).

In addition, in light of the potential benefits of business level expenditure taxes there is likely to be increased interest internationally in them as a replacement for company income taxes. Such a system may suit Australia and is worthy of further consideration and public debate. It is possible that other economies will move towards such systems over coming years and it could be in Australia's interest to join this trend at an early stage. An example of a blueprint for the reform of Australia's company income tax system, based on the allowance for corporate equity, is presented in Sørensen and Johnson (2010).

### **Recommendation 26:**

The structure of the company income tax system should be retained in its present form, at least in the short to medium term.

A business level expenditure tax could suit Australia in the future and is worthy of further consideration and public debate. It is possible that other economies will move towards such systems over coming years and it could be in Australia's interest to join this trend at an early stage.

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7 No country has replaced their company income tax system with a destination business cash flow tax. The allowance for corporate equity has been adopted by Belgium (2005) and Latvia (2009) and was also used in Croatia for a short period of time.

## Reducing company income tax would boost investment across the economy

As discussed previously, economic theory and growing empirical evidence support a shift away from company income tax towards taxes on less mobile factors as a means of increasing investment, GDP and growth. Over the past 25 years, company income tax rates across the OECD have fallen, and until more recently, Australia has followed this trend. However, Australia's current company income tax rate is now high relative to similar sized OECD economies.

The company income tax rate should be reduced to encourage investment in Australia, particularly highly mobile foreign direct investment. In the long-run this would increase income for Australians, by building a larger and more productive capital stock and by generating technology and knowledge spillovers that would boost the productivity of Australian businesses.

In the long-term, a larger and more productive capital stock would not only result in higher growth but is also likely to result in higher wages. A lower company income tax rate would also reduce incentives for foreign multinationals to shift profits out of Australia.

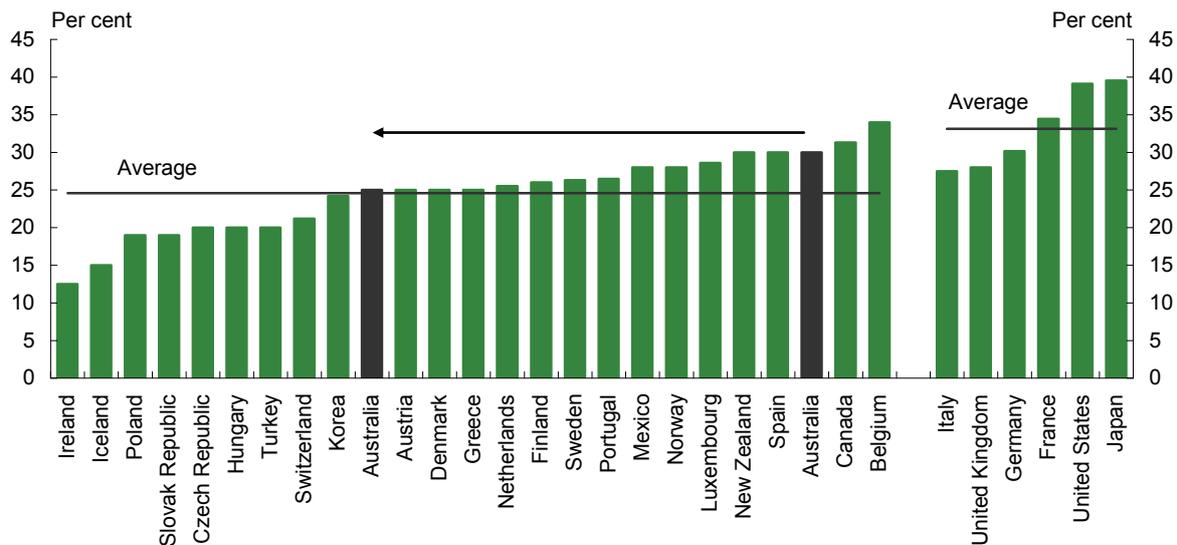
Given the continued expected growth of China and India, Australia should continue to be able to attract investment into its resource sector. However, other sectors of the economy may find attracting investment more challenging. Reducing the company income tax rate may help other sectors attract investment.

Against this, company income tax currently has an important role in ensuring the community receives a return for the exploitation of Australia's non-renewable resources. Reducing the company income tax rate in the absence of other measures would lead to lighter taxation of Australia's location-specific rents. But it would be more effective to tax such rents directly, through a uniform resource rent-based tax, as recommended in Section C1 Charging for non-renewable resources.

The benefits of a reduction in the company income tax rate also need to be considered against potential interactions with the personal tax and transfer system. For example, a reduction in the company income tax rate would increase incentives for domestic residents to defer taxation by retaining income in a company.

Taking account of these considerations, the company income tax rate should be set on the lower side of the average rate in small and medium OECD economies, while balancing other considerations such as interactions with the personal tax-transfer system (to minimise incentives to defer or avoid taxes on labour and savings).

A move over the short to medium term to a company income tax rate of around 25 per cent would be consistent with this approach, and allow for the transition to that lower rate to take account of fiscal and economic circumstances over that period (see Chart B1-7). Given that 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 non-renewable resources should be introduced at the same time.

**Chart B1–7: Restoring Australia’s relative company income tax rate ranking**

Source: OECD (2009d).

A number of submissions to the Review have also recommended a concessional tax rate for small companies. A lower company tax rate targeted at small companies would only benefit companies and owners that are in a position to accumulate funds in the company. Furthermore, it would target a company income tax rate cut at those businesses most likely to be earning a return to the personal efforts and savings of owner-managers, thereby negating the backstop functions of company income tax while attracting little additional investment or otherwise improving productivity. It could also benefit non-business accumulation, such as rents and profit retention.

Certain tax arrangements or concessions may need to be adjusted in response to a reduction in the company income tax rate. This would include adjusting the level of the research and development tax credits (in respect of the loss offset component) and maintaining the current effective 10 per cent tax rate for offshore banking units.

#### **Recommendation 27:**

The company income tax rate should be reduced to 25 per cent over the short to medium term, with the timing subject to economic and fiscal circumstances. Improved arrangements for charging for the use of non-renewable resources should be introduced at the same time.

## **B1–4 Refining the business income tax base**

To avoid a misallocation of resources that can reduce productivity, the business income tax base — for both companies and other entities — should be as broad as possible with few exemptions and concessions. Where income is measured incorrectly for tax purposes, investment may be directed towards less productive assets that would not be viable in the absence of the tax bias. There are also likely to be benefits from minimising biases around other business choices, such as the choice of business entity (see Section B2 The treatment of business entities and their owners), risk taking and financing choices.

However, the uniform taxation of all investments and business choices may not always be efficient. It may be more efficient to tax some investments more highly, such as those that earn economic rents that are specific to Australia, while other specific investments could be taxed more lightly if they generate spillover benefits that improve the wellbeing of Australian society more generally.

Furthermore, given the difficulties in calculating real income the administration and compliance costs of trying to tax business income uniformly may exceed the benefits.

## **Taxing investments more consistently**

### **Measuring income correctly can be difficult**

If the tax system measures income incorrectly, this can bias the level and pattern of investment. Difficulties include adjusting for inflation and measuring changes in real asset values (depreciation, capital gains and stock valuation). All of these issues can result in biases to firms' investment decisions.

Inflation aside, incorrectly measuring the rate of economic depreciation for tax purposes may favour investment in less productive assets. This reduces productivity and economic growth. However, it is hard to measure economic depreciation accurately.

Rates of economic depreciation will depend on a number of factors including the type of asset, how it is used and where it is used. At best, capital allowance provisions provide an approximation of economic depreciation measured as the change in value of a machine or building over an accounting period. The practical problem is how to reduce biases given real-world uncertainties.

### ***Some deviations from economic income may correct market failures***

In some circumstances deviations from economic income may have some merit, where this can correct for market failures.

Innovation and technological progress by businesses can take the form of product innovation or process innovation to increase efficiency and productivity. Such progress therefore encompasses a vast array of factors in the economy, including workforce skills, management, venture capital, technology uptake, work reorganisation, and research and development.

Where the research and development of a firm generates spillover benefits for others, the social returns from research and development may be greater than the private returns. A tax-preference or government expenditure that appropriately targets such spillovers may therefore be beneficial and improve overall productivity.

But where a subsidy is inappropriately targeted, such incentives can bias the allocation of resources in the economy and actually reduce productivity.

As innovation policies have recently been the subject of review, detailed consideration has not been given by the review to the arguments and evidence for encouraging research and development. While contestable, there is some evidence to support the use of subsidies or concessions to encourage research and development. For example, research and development expenditure has been found to be highly sensitive to tax incentives (Johansson et al. 2008).

## Principle

The business income tax base should be as comprehensive as possible to ensure investment is allocated to its most productive uses. This must be balanced against the benefits of correcting market failures and the practical difficulties in achieving a completely uniform treatment of different investments.

## Current depreciation arrangements are distortionary

The tax treatment of assets varies considerably under the current tax system. Differences arise from difficulties in determining economic income and from a history of discrete government decisions.

The overall impact of the income tax system on resource allocation and investment decisions is unclear. Tax concessions arise from tax exemptions and concessional rates, tax offsets or the deferral of tax liabilities. There are also tax arrangements that effectively impose an additional charge on the taxpayer, such as limitations on the use of losses, while special provisions, such as income averaging, are needed to minimise other adverse affects of the tax system.

Many of these arrangements interact with each other. For example, there are a number of special provisions that apply to different uses of agricultural land. These include special tax arrangements for investors in forestry managed investment schemes and agricultural managed investment schemes and accelerated write-off for establishment costs of carbon sink forests. In these cases the inconsistent treatment adds to the complexity of the tax system and is also likely to distort land use allocation.

One way to examine the potential impacts is to compare effective tax rates across different sectors. Markle and Shackelford (2009) estimate effective tax rates by industry using financial statement information for a number of countries. Their country-specific estimates show significant variation in effective tax rates across sectors. For example, for Australia they find the highest effective tax rate is in the financial services and retail trade sectors (27 per cent) and the lowest in the information and mining sectors (14 and 17 per cent respectively). As shown in Table B1-2, the results for Australia are typical of those across the other countries surveyed.

**Table B1-2: Effective tax rates by industry, selected countries (domestic)**

	Australia	Canada	Japan	United Kingdom	United States
All industries	24	24	39	26	26
Construction	23		36	21	25
Financials	27	13	36	26	15
Information	14	19	35	21	19
Manufacturing	25	24	38	25	28
Mining	17	17			22
Other	24	23	41	26	30
Professional	19		36	24	21
Real estate	23		40	26	24
Retail trade	27		44	27	34
Transportation	22		39	25	24

Source: Markle and Shackelford (2009), Table 4.

While other factors have an important influence on the allocation of investment in Australia, tax disparities tend, at the margin, to cause resources to move into less-productive

investments in tax-favoured industries at the expense of more-productive investments in less-favoured industries. Overall productivity performance will be held back if there is over-investment in one tax-favoured sector at the expense of investment in other sectors that may be potentially more productive.

Tax disparities could also influence the way in which the economy may respond to a lowering of the company income tax rate. Industries with an already low effective tax rate could be expected to be less responsive than those with relatively high effective rates, all other things being equal.

### **Some assets are concessionally taxed**

Following the recommendations of the Review of Business Taxation, Australia's capital allowance regime moved to a system based on the effective life of the asset (uniform capital allowances). The aim of effective life depreciation is to provide a neutral treatment across depreciating assets, aligning the rate of depreciation for tax purposes more closely with economic depreciation. This should reduce the distortions induced by tax across different assets, but a number of distortionary arrangements still remain.

For a small number of assets the effective life is capped or alternative capital allowance provisions apply. Statutory effective life caps currently apply to tractors, harvesters, trucks, buses, aircraft, helicopters and gas transmission and production assets.

These accelerated capital allowance provisions may result in significantly lower effective marginal tax rates for eligible investments relative to assets whose capital allowances are based on effective life. However, in some cases the statutory effective life cap may offset the impact arising from the fixed declining balance parameter being too low.

Another area of departure is the capital allowance rate for capital works, such as buildings and structural improvements. Taxpayers can claim a deduction for capital works at either 2.5 per cent (over 40 years) or 4 per cent (over 25 years) of the construction expenditure.

The rate depends on when construction started and how the capital works are used. The United Kingdom is phasing down allowances for industrial buildings, on the grounds that its tax system already recognises the depreciation of buildings and structures in other ways – through tax relief for the costs of repairs and insurance, and by directly recognising any actual depreciation (or appreciation) through the capital gains tax system (HM Treasury 2007).

Certain expenditure can be written-off immediately, even though it should be capitalised into an asset and depreciated over its effective life. For example, expenditures relating to the creation of intangibles like goodwill (discussed further below), certain repairs and maintenance and exploration expenditure (which can be immediately written-off even when exploration activity is successful or may still prove successful).

A number of submissions also suggest that longer-life assets should be written off at faster rates. However, under the current arrangements, where capital allowance deductions are based on historical cost, the system will favour more durable assets in the presence of inflation (Auerbach 1979). That said, the actual impact is less clear when other elements of the tax system are also considered. For example, to the extent longer-life assets are more

risky, the current imperfect loss offset provisions (discussed below) may discourage investment in them.

### ***Investment in intangibles is generally favoured***

Investment in creating goodwill and other intangibles is currently taxed more generously than investment in many tangible assets. Expenditures incurred to create 'new' goodwill, such as marketing costs, are immediately deductible for tax and accounting purposes even though the economic benefits persist over time.

In contrast, acquired goodwill and other intangibles are taxed under the capital gains tax provisions. They cannot be depreciated for tax purposes, and gains (or losses) are taxed only when the asset is sold and the gain or loss realised. This treatment applies because of the practical difficulties under an income tax system in estimating the value of goodwill when it is acquired and the annual change in value.<sup>8</sup> While acquired goodwill cannot be written-down for tax purposes, where it declines in value, any expenditure incurred in maintaining its value is immediately deductible. In many cases, this will approximate economic depreciation.

Under the capital gains tax provisions, any reduction in the value of previously acquired goodwill is effectively deducted when a business is sold. This is because the value of acquired goodwill is included in the cost base for measuring any capital gain or loss.<sup>9</sup> If acquired goodwill were amortised, it would be deductible earlier, whereas gains from the creation of goodwill or any increase in the value of acquired goodwill would not be recognised until realisation. Allowing acquired goodwill to be written-off would therefore increase the overall tax preference in favour of intangibles.

### ***The current arrangements are complex***

A number of submissions also highlighted the complexity of the current capital allowance arrangements and the record keeping requirements associated with them.

The complexity of the existing system largely reflects the fact that Australian businesses use many different types of assets in their operations, each of which has its own effective life. Under the uniform capital allowances rules there are 40 different effective lives based on the Commissioner's current determination. Effective lives are provided for over 3,700 assets, of which around 400 are general use assets not specific to any particular industry or sector.

Complexity is also increased because special or preferential arrangements apply to certain assets or types of taxpayer. As discussed, buildings have their own specific arrangements, falling outside the uniform capital allowance system, while low-value assets, with a value of \$1,000 or less, can be pooled together and depreciated at 37.5 per cent per year, and certain assets costing \$300 or less are immediately deductible. Separate capital allowance arrangements are also available for small business.

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<sup>8</sup> Difficulties in measuring the acquisition cost of goodwill arise because goodwill is typically measured as the residual amount remaining after values have been allocated to other assets. In some circumstances this can create an incentive to manipulate value allocations to provide the most favourable tax treatment.

<sup>9</sup> Where goodwill is sold at a loss, as with all capital losses, it can only be used to offset a capital gain.

## Findings

While previous reforms to Australia's capital allowance arrangements have reduced distortions to investment decisions and some aspects of complexity, there remain a number of distortions that may encourage investment in less productive assets and the system remains complex.

Investment in creating intangibles is currently taxed more generously than investment in many tangible assets, reflecting the inherent difficulties in valuing intangibles.

## Enhancing productivity and simplifying the capital allowance arrangements

The current capital allowance arrangements could be enhanced and simplified without significant adverse implications for resource allocation. A simplified system should be designed in such a way as to provide broadly the same capital allowance deductions as under the current law, but under a simpler, more streamlined arrangement.

Any simplification of the current regime risks biasing investment decisions by providing capital allowances that are less closely matched to economic depreciation. But given the difficulties in measuring the true decline in the value of an asset, it is unclear how significant any biases would be relative to the current arrangements.

In particular, the existing low-value pool should be abolished, and instead all assets with a value of less than \$1,000 should be immediately deductible for all taxpayers — apart from those eligible for the small business concessions, who can already write off assets with a value of less than \$1,000 and for whom an increase in this threshold is recommended (see 'Arrangements for small business (including sole traders)' below). This would reduce record keeping requirements by removing the need to maintain a low-value pool.

Consideration could separately be given to grouping assets with a related purpose or use, and having a single capital allowance rate for all assets in the group, based broadly on the effective life of assets within that group. For example, all information technology equipment could be grouped together.

To improve overall productivity, existing concessional arrangements should also be reconsidered, including statutory effective life caps, capital works (including buildings), exploration expenses and the taxation of agriculture and forestry more generally. But any review of the existing concessional arrangements, including effective life caps, would need to be mindful of the effective depreciation rate for tax purposes relative to the actual rate of economic depreciation and other related elements of the tax system.

**Recommendation 28:**

The capital allowance arrangements should be enhanced and streamlined to ensure effective rates more closely match rates of economic depreciation, and to reduce administration and compliance costs overall. This should include:

- (a) allowing low-value assets (assets costing less than \$1,000) to be immediately written-off; and
- (b) reviewing the impact of special provisions applying to different investments in agriculture and statutory effective life caps and other concessional write-off provisions.

***Arrangements for small businesses (including sole traders)***

To simplify and provide more certainty over the taxation arrangements for small business entities (including sole traders) in particular (and to provide a cash-flow benefit to such businesses), the threshold for determining a low-value asset for small businesses should be increased to \$10,000. This would allow small businesses to immediately write-off most of their asset purchases.

Arrangements for small business should be simplified further by allowing any remaining depreciating assets (other than buildings) that are not immediately written-off to be grouped in a single pool (rather than the two existing pools), with the entire pool written off at a single declining balance rate.

In addition, the operation of the pool could be further simplified by removing the requirement for small businesses to calculate a balancing adjustment on sale or disposal of an asset. This would remove the requirement for small businesses to keep track of individual non-immediately deductible assets. Instead, capital allowances would continue for the asset pool, but any proceeds from the sale of an asset would be included in the taxpayer's income.

Combined with the recommendation to streamline and improve access to the small business capital gains tax concessions (Recommendation 17), and the Standard Business Reporting program, these measures would result in a significant simplification for small businesses.

Access to these small business tax concessions, and others under the small business tax framework, should also be extended by increasing the current \$2 million turnover 'small business entity test' to \$5 million.

**Recommendation 29:**

The capital allowance arrangements for small business should be streamlined and simplified, by:

- (a) allowing depreciating assets costing less than \$10,000 to be immediately written-off; and
- (b) allowing all other depreciating assets (except buildings) to be pooled together, with the value of the pool depreciated at a single declining balance rate.

### **Recommendation 30:**

The small business entity turnover threshold should be increased from \$2 million to \$5 million, and adjustments to the \$6 million net asset value test should be considered.

## **Supporting an appropriate level of risk-taking**

### **Risk-taking can be discouraged by the treatment of losses**

The tax system treats gains and losses differently. The current tax system limits the refundability of losses, while all gains are taxed as they are realised. This reduces incentives to undertake risky investments, as denying full loss offset reduces the expected return from, and therefore increases effective tax rates on, risky investments.

Where losses are not fully refunded or where gains and losses are taxed at different rates, as under a progressive tax rate scale, these asymmetries will tend to discourage risk taking including entrepreneurial activity. Restrictions on loss utilisation may also lead to pressure for concessions to attract investors to investments that are disadvantaged as a result of the restrictions. If such concessions are targeted towards specific types of investments, they risk further biasing investment allocation.

Limitations on the use of losses may in particular disadvantage small businesses and firms engaged in risky investments, with start-up or closing down expenditure and without other income to offset losses against. In 2006–07, small businesses accounted for almost half of all carried forward tax losses in Australia.

This bias against small business may lead to greater market concentration, because larger more diversified businesses may have a higher expected post-tax return when they have other income to use against a loss against. It may also result in inefficient takeover activity, where entities carrying losses forward are valued more highly by entities that can utilise those losses.

Restrictions on loss utilisation also limit the ability of the tax system to serve as an automatic stabiliser during a downturn. This is because the tax value of deductions is not recouped by companies until they have income to offset losses against.

However, despite its theoretical benefit, full loss offset is rarely seen in practice.

In the same way that profits are highly mobile and can be shifted between countries in response to high statutory tax rates, full refundability could attract losses into a country at a substantial cost to revenue — without necessarily improving the climate for investment. While loss restrictions are an imperfect substitute for effective integrity provisions, they limit the benefits of tax avoidance schemes. They also limit the benefits arising from any income mismeasurements, such as immediate deductions for capital expenditure and accelerated capital allowance arrangements.

Loss restrictions, such as continuity of ownership tests, also prevent losses from being transferred to new investors who may value them more highly because of differences in tax rates. Further, loss restrictions may limit the extent of a bias in favour of debt financing by

companies and, in respect of trusts, may reduce the scope to exploit differences in the tax rates of trust beneficiaries.

### Principle

The treatment of business losses should reduce biases against risk taking by treating income and losses symmetrically. This must be balanced against problems arising from the mismeasurement of losses from difficulties in measuring economic income, artificial loss creation schemes or from other forms of tax avoidance.

The current tax system treats gains and losses asymmetrically. Gains are taxed as they accrue while losses are not refunded but can be carried forward and used against future income, subject to certain tests. There are two main tests to determine whether or not a loss can be utilised: the continuity of ownership test and the same business test.

Despite these tests, a considerable degree of loss utilisation is in effect permitted other than through the loss carry-forward provisions. For example, sole traders and partnerships are able to flow through their losses to owners, and wholly-owned corporate groups are allowed to offset losses in one subsidiary against income from others under the consolidation regime.<sup>10</sup> Recent changes to research and development tax arrangements will also improve loss utilisation.<sup>11</sup>

A number of submissions to the Review have also noted that the current loss utilisation rules add significant complexity and uncertainty to the tax system.

### Finding

The current tax system treats gains and losses asymmetrically. This treatment may have an adverse effect on risk taking and entrepreneurship.

### Limiting biases against risk taking

The benefits from reducing the existing tax bias against risk-taking, and at the same time increasing the degree to which business income tax arrangements act as an automatic stabiliser, emphasise the value of improving the current income tax treatment of losses.

The Review has not attempted to evaluate fully all options for improving loss arrangements, given that careful account also needs to be taken of the risks associated with the mismeasurement of losses. Given that the latter depends on other policy choices, including further reforms to enhance the comprehensiveness of the business income tax base (see Recommendation 28), taxpayer behavior and the effectiveness of the tax administration, the right balance between these competing considerations may vary over time and sometimes require reassessment.

<sup>10</sup> The Government has recently announced measures to further restrict the deductibility of business losses for high-income individuals.

<sup>11</sup> A key aspect of the announced changes is the move away from accelerated deductions to a system of tax credits (offsets). This neutralises the existing bias in the tax system associated with the treatment of losses. In effect, the offset to be provided consists of two parts: a loss offset (at 30 cents in the dollar) and a subsidy to encourage innovation (at 10 or 15 cents in the dollar).

Companies should be able to offset losses made in a particular income year against taxable income from the preceding year. This would allow companies to receive an immediate tax refund to the extent the company paid tax in the previous year. Without this, the timing of the income year can lead to over-taxation as it does not consider expenditure that falls narrowly outside the income year. While there would be some increase in complexity, the change would also improve the ability of the tax system to serve as an automatic stabiliser, particularly for small companies, and reduce reliance on ad hoc relief for businesses under stress (Abhayaratna & Johnson 2009).

As taxpayers can time the realisation of capital losses, it is recommended that this proposed loss carry-back be restricted to revenue losses. Further, due to Australia's imputation system, provisions would also be required to prevent losses from being offset against prior year tax payments that have been distributed to shareholders as imputation credits. To address this, it is recommended that the carry-back arrangements be limited to the amount of franking credits retained in the company.

Loss carry-back provides limited benefits to start-up businesses, small businesses and businesses engaging in high risk activities. There is no single solution for providing a better loss treatment for these businesses and activities. Recommendation 32 represents a targeted approach in regard to exploration, an activity that involves relatively small start-ups undertaking high risk investments. Other such opportunities could be further considered. There may also be merit in reviewing the continuity of ownership and same business tests to give greater weight to simplicity and certainty objectives.

#### **Recommendation 31:**

Companies should be allowed to carry back a revenue loss to offset it against the prior year's taxable income, with the amount of any refund limited to a company's franking account balance.

#### ***Flow-through treatment for exploration***

The Australian Government asked the Review to consider a proposal to promote exploration investment by adopting flow-through share schemes for smaller operators in the gas, oil and mineral exploration industries. The issues raised by the proposal illustrate some of the issues associated with the treatment of losses and, related to that, the measurement of income.

The current treatment of tax losses puts small exploration companies at a competitive disadvantage relative to larger, more diversified companies and to business investments in other sectors. This is because losses generated by exploration companies often cannot be used to offset other taxable income. At the same time, the immediate deduction for exploration expenses generates non-economic tax losses when exploration is successful.

The impact of providing special arrangements for losses incurred as a result of exploration activity has not been fully evaluated by the Review. While the current treatment of losses may disadvantage exploration relative to other investments, targeted provisions for expenditure on resource exploration could reverse that bias and favour investment in exploration at the expense of other, potentially more profitable, investment opportunities.

Canada has adopted a flow-through share scheme arrangement under which income tax deductions associated with exploration are, in effect, made available to shareholders. Other

tax credits, at the federal and provincial levels, are also available for qualifying investors, including a 15 per cent credit for expenditure associated with new resources or fields.

Submissions to the Review have proposed the following features for a flow-through share scheme:

- An exploration tax credit would be allowed to resident shareholders of Australian companies for Australian exploration expenditure incurred by those companies.
- The credit would be available at the company income tax rate (currently 30 per cent), possibly with an uplift and would be refundable.
- Credits could not be distributed to shareholders where the company itself pays company income tax (effectively limiting the scheme's availability to small companies).
- Dividend imputation rules would be drawn on where possible (including anti-streaming and anti-credit trading rules).

While the current tax treatment of losses creates a tax bias against small explorers, the flow-through share proposal, as described, may over-correct the bias. Even without an uplift, a 25 or 30 per cent credit would provide a significant tax incentive for superannuation funds to invest in a sector when any returns would only be taxed at 7.5 per cent (see Recommendation 19).

There are no strong grounds to believe that exploration generates unusually large positive spillovers that would justify a subsidy. Exploration does produce information of public value, and explorers are required to make such information publicly available. However, nearly all activities generate information that is of benefit to others; for example, that a particular business model does or does not work.

Further, as the flow-through share design is targeted at resident shareholders (to improve marketability) rather than at the company level, it makes the design of a flow-through scheme more complicated and therefore is likely to result in higher administration and compliance costs. It would also not assist in attracting investment from non-resident investors.

The existing tax bias arising from the treatment of losses could be addressed by using a targeted, company-level approach to increase loss utilisation. For example, it would be possible to allow the company to choose to defer taking a deduction in respect of exploration expenditure (effectively allowing loss transfers) or, preferably, to provide a refundable tax offset for designated expenditure set by reference to the company income tax rate and with appropriate adjustment to franking account rules. The detailed design of the rules would need to be the subject of further consideration and consultation.

### **Recommendation 32:**

If earlier access to tax benefits from exploration expenses (relative to other expenses) is to be provided, it should take the form of a refundable tax offset at the company level for exploration expenses incurred by Australian small listed exploration companies, with the offset set at the company income tax rate.

## Reducing financing distortions

### Financing choices of business can be distorted

Most company income tax systems, including Australia's, tax the full return to equity only, with interest payments deductible from the company income tax base. This provides companies with a tax incentive to finance investment with debt rather than equity capital. The debt-equity distortion may, however, be reduced where companies are unable to use deductions for interest payments, such as where a company is in a loss situation.

Over reliance on debt makes companies more vulnerable to insolvency and to economic shocks, and may have implications for macroeconomic stability. Providing a deduction for debt and not for equity financing may also discriminate against smaller businesses, and knowledge-based industries that invest more heavily in intangibles. Such businesses may have more difficulty borrowing.

The treatment of debt and equity for tax purposes is complex and creates opportunities for tax avoidance. This has been compounded over recent years with the increased innovation in financial products, often devised to exploit the difference in the tax treatment of debt and equity. As a result of this innovation, the traditional distinction between debt and equity has become even less clear. Increased globalisation has also increased opportunities for tax arbitrage, particularly where countries take different views as to whether a particular instrument qualifies as debt or equity.

The implications of the tax treatment of debt and equity depend in part on the source of finance for specific businesses. The following sections consider the implications for businesses with and without direct access to foreign capital.

### *Businesses that rely on domestic finance*

To the extent that capital is not perfectly mobile, as may be the case particularly for small unlisted domestic firms, financing decisions may be influenced by taxes on capital income (dividends, capital gains, interest) at the personal level.

Where businesses do not have access to international capital — that is, they may effectively operate in a closed economy — the tax preference in favour of debt relative to equity at the company level may be offset by Australia's dividend imputation system. However, even with dividend imputation and with a closed economy assumption, investments financed by retained earnings are likely to be favoured over new equity, because of the concessional taxation of capital gains.

When earnings that would otherwise have been used to pay dividends (and been taxed in the hands of the recipient) are retained in the company, the value of equity increases and shareholders are rewarded with an accrued capital gain which is taxed preferentially on realisation at reduced rates. The shareholder can therefore delay paying tax until the share is sold and the gain realised.

As dividends and interest income are taxed at full marginal rates for domestic savers, investments financed by new equity and debt need to earn a higher return relative to investments funded by retained earnings. This higher return is required to compensate for the tax penalty they face relative to concessional tax capital gains.

However, while smaller companies and businesses may not have direct access to foreign capital, much foreign debt capital is raised by Australian banks or financial institutions who then on-lend to the business sector generally. The cost of equity capital for larger firms, to the extent that it is set by access to international equity, will also influence the cost of equity for smaller firms. Hence, even for this sector or group of businesses, the biases outlined for businesses with access to international finance will still be relevant.

### ***Businesses with access to international finance***

Where the marginal source of finance is the international capital market, the deductibility of interest from the business income tax base would appear to favour higher levels of debt, driven by the company or relevant income tax rate.

Interest deductibility biases the capital structure of a business towards higher levels of debt — increasing its risk exposure. Distorting these choices may discourage businesses from adopting the best approach to managing other factors associated with their capital structure. To the extent that interest withholding tax applies on the payment of interest to the non-resident investor, it may moderate the bias against equity.

For a multinational company investing in Australia through an Australian subsidiary, the allocation of debt or equity capital to that subsidiary may be motivated in part by tax planning considerations, and not directly affect risk exposure given parent guarantees over any debts of the subsidiary.

Australia's thin capitalisation and transfer pricing rules aim to safeguard against excessive interest charges being allocated to the Australian subsidiary, either by restricting deductibility for businesses that operate at above a specified level of gearing or by policing the interest rate. In this regard, the thin capitalisation rules can be seen as placing a limit on the degree to which the normal, risk-adjusted, return from an investment in Australia can be excluded from Australian tax (by being characterised as a return on debt) and the extent to which it is taxable (as the return on equity). The transfer pricing rules can be seen as a means of restricting the ability of firms to avoid tax on supernormal returns. Together, these rules play a role in ensuring what is judged to be the appropriate level of tax is collected from investment in Australia.

At an economy wide level, the overall bias in favour of debt — together with the incentive provided by dividend imputation and the capital gains tax discounting rules for domestic residents to hold domestic equity — might be reflected in a relatively high share of debt finance in the capital account of the balance of payments. For an individual firm, debt financing can exacerbate vulnerability in the profit and loss statement when revenue falls, as the debt servicing costs are essentially unavoidable, short of default — unlike dividend payments. The increased vulnerability of firms would be expected to magnify the impact of financial shocks and other sources of macroeconomic instability.

Tax-induced distortions to financing decisions should be reduced to avoid encouraging firms to rely excessively on debt finance and to avoid biasing other financial decisions, such as dividend payouts. However, outside of the business level expenditure taxes outlined previously, it is difficult to reduce distortions to financing decisions.

## Principle

Thin capitalisation and transfer pricing rules should continue to be used as mechanisms to ensure that what is judged to be the appropriate level of tax is collected from investments in Australia.

### The current treatment of foreign debt is complex and distortionary

Interest paid on foreign debt is deductible against the company income tax base (subject to the thin capitalisation rules) but the non-resident lender may be subject to interest withholding tax. While interest withholding tax is applied notionally at a rate of 10 per cent, in aggregate the effective tax rate is around 3.5 per cent given the wide range of available exemptions (see Table B1-3).

**Table B1-3: Interest withholding tax rates and exemptions**

Foreign debt	Interest withholding tax rate (IWT)
<i>Exemption dependent on borrower</i>	
Australian investor borrows from non-resident lenders through a publicly offered debenture issue, non-equity share or syndicated loan	Exempt
Australian branch of foreign bank borrows from its parent	5% IWT on notional interest (based on LIBOR)(a)
Australian bank borrows from non-resident retail investors (retail deposits, in Australian parent)	10% IWT
Offshore banking unit (borrows offshore and on-lends offshore)	Exempt
Australian Government bonds	Exempt
State government bonds	Exempt
<i>Exemption dependent on lender</i>	
Australian investor borrows from foreign financial institution	Exempt for institutions located in US, UK, Norway, France, Finland, Japan, South Africa and New Zealand (cf. tax treaties) (b). Otherwise, 10% IWT
Australian investor borrows from sovereign wealth fund	Exempt (exemption administered by ATO)
Australian investor borrows from foreign superannuation fund that is tax-exempt in its country of residence	Exempt
<i>No exemption available</i>	
Other related party borrowings	10% IWT

(a) London Interbank Offered Rate.

(b) This exemption is being extended to other countries over time.

Although interest withholding tax is imposed on the non-resident lender, it is likely to be passed onto Australian borrowers by way of higher interest rates on their borrowings — increasing their cost of capital and reducing domestic investment. In large part this is likely to depend on whether the non-resident lender is able to receive a credit for the interest withholding tax paid in their home jurisdiction.

The extent to which interest withholding tax is a creditable tax is unknown. As most countries tax interest income on a residence basis, the formal creditability of interest withholding tax would be expected to be relatively high. But, there are a number of situations where it may not be creditable, or, even where credits are available, they may not be valued in whole or part by the lender.

A potential benefit of interest withholding tax is reducing the tax bias, in respect of international capital, in favour of debt over equity. However, the extent and nature of the exemptions available mean that in practice this benefit is likely to be minor.

In turn, those exemptions generate distortions of their own that appear more significant. In particular, the current arrangements are likely to influence how Australian businesses and households access foreign debt capital, potentially distorting competition between financial service providers and reducing the stability of the financial system, and leading to a misallocation of that capital away from its most productive uses in favour of less productive investments that have better access to debt.

While it is difficult to estimate how large these potential costs may be, the current rules potentially favour domestic financial institutions raising funds offshore through wholesale markets rather than retail deposits, increasing their vulnerability in periods of financial turmoil. They also favour borrowing directly from banks in certain countries, over banks in other countries or the Australian branches or subsidiaries of foreign banks generally, favouring less commercially competitive forms of intermediation.

An important benefit of the current interest withholding tax arrangements is that they act as a brake on tax avoidance schemes by residents, such as the routing of income through offshore structures with the income then returned in a tax exempt form (such as a foreign non-portfolio dividend received by an Australian company). Interest withholding tax can reduce the tax benefit of such schemes, and also generate information for use by tax authorities.

Interest withholding tax also limits the tax advantage to multinationals from thinly capitalising their Australian subsidiaries or branches or paying interest at excessive rates. In this respect, interest withholding tax supports the thin capitalisation and transfer pricing rules.

### Finding

Foreign capital invested in Australia in the form of debt is subject to low effective tax rates, primarily through interest withholding tax. That tax currently helps safeguard the taxation of foreign equity and of resident savings. But it may negatively affect the financial sector by distorting the way foreign debt is accessed.

### Reducing distortions in how foreign debt is accessed

Distortions in the access to and intermediation of foreign debt could be reduced by generally not applying interest withholding tax to interest paid to non-residents by financial institutions operating in Australia.

While the precise boundaries of the exemption require separate consideration, it is expected that this targeted interest withholding tax exemption would cover authorised deposit-taking institutions such as banks, building societies and credit unions, as well as other financial institutions (such as money market corporations).

The exemption would not, however, extend to debt accessed through the corporate treasury of a multinational group. This would ensure that interest withholding tax would remain payable on the related party debt of Australian businesses other than financial institutions.

The exemption would also not apply to insurers or fund managers, who are engaged in investing in financial instruments rather than being a source of debt capital for Australian businesses.

For non-resident retail deposits in Australia, the compliance and integrity issues arising from this recommended exemption would need to be further considered. For example, retaining interest withholding tax on such deposits would avoid increasing incentives for resident savers to claim non-resident status. While some compliance costs are imposed by requiring Australian financial institutions to withhold tax from interest paid on retail deposits, financial institutions are already required to operate tax file number withholding.

Australian businesses that are not financial institutions would continue to be able to access the existing exemptions for publicly offered debentures and certain debt interests. But consideration should be given to streamlining these rules.

There may also be scope to remove interest withholding tax on a bilateral basis in tax treaties, as recently agreed between the United States and Canada. Tax treaties, by providing scope for the effective exchange of information, may guard against the risks of potential tax avoidance by resident savers which could arise where unilateral abolition is pursued.

#### **Recommendation 33:**

Financial institutions operating in Australia should generally not be subject to interest withholding tax on interest paid to non-residents.

#### **Recommendation 34:**

Consideration should be given to negotiating, in future tax treaties or amendments to treaties, a reduction in interest withholding tax to zero so long as there are appropriate safeguards to limit tax avoidance.

## **Managing the investment of foreign savings**

### **Tax can affect the ability of Australian business to manage foreign savings**

Multinational companies, managed funds and related corporate and investment management services can be seen as providing a service to manage domestic and foreign savings by investing it domestically and overseas.

For such entities in Australia, taxing their foreign source income (whether by company income tax or withholding taxes) as it flows to non-resident investors could effectively act as a toll on non-residents using Australian rather than foreign managers. The toll would be on top of any general source-based tax on the profits from the service of managing capital. It would create a bias against the Australian provision of such services, potentially allocating resources away from their most productive use.

The location of managed funds and related services is particularly likely to be sensitive to such taxes. Given the ease with which savings can be reallocated between different funds, any tax on the income flows to the underlying investors can significantly affect the ability of Australian-based operations to compete. A small amount of Australian tax on the underlying

conduit income, or the risk of such tax, can give rise to a very high effective tax rate on the value added by the Australian based activity.

Conceivably, aspects of Australia's commercial environment, including political stability, effective legal system, governance arrangements and a reasonably well-developed and sophisticated financial services sector, could generate location-specific rents for such business services. However, other factors, such as the relatively small size of Australian financial markets and geographical isolation, are likely to mean that these rents are low.

Many of these features are also found in other countries, and funds management and related services, in particular, are likely to be highly mobile and operate in highly competitive environments. There is therefore a case for not taxing the foreign source income of Australian entities, companies or funds, as it flows to or is realised by non-resident investors, while still taxing the Australian source income arising from the management activity in Australia.

While there is an in-principle case to generally exempt such conduit income, there are a number of competing considerations that also need to be taken into account. Conduit income tax relief may not be appropriate where, for example, it disproportionately increases administration or compliance costs, or compromises the ability to appropriately tax resident savings or (to the extent it is desirable) the Australian source income of non-residents, or is inconsistent with international tax coordination objectives or norms.

The highly mobile nature of some financial services also provides, in theory, a case, not only for not taxing conduit income, but also reducing the source-based taxation of the highly mobile activities undertaken by Australian intermediaries. Australia's offshore banking unit regime is an example of this approach. However, reducing the source-based taxation of highly mobile activities gives rise to the potential misallocation of domestic investment and practical difficulties, including problems with targeting any concessions. Preference should therefore be given to broader structural responses such as minimising taxes on conduit income.

### Principle

To avoid penalising the management of foreign savings in Australia, investment taxes should not apply to the conduit income of Australian companies and managed funds. This needs to be balanced against practicality, international constraints and ensuring the taxation of resident savings or source-based investment taxes are not compromised.

### The treatment of conduit income is mixed, particularly for managed funds

The conduit income of Australian multinationals is largely exempt from Australian investment taxes. This is achieved by the exemption provided to dividends received by an Australian company from a foreign company in which it has a significant (non-portfolio) holding, and the capital gains tax exemption that can also apply to the sale of such interests. These arrangements are consistent with an international trend to exempt non-portfolio dividends received from foreign companies from company income tax.

Further, dividends paid to foreign shareholders out of conduit foreign income are expressly excluded from dividend withholding taxes, and capital gains tax does not generally apply to

sale by non-residents of shares in Australian companies. The trend in Australia's tax treaties of reducing withholding taxes has also acted to reduce tax on conduit income.

Exceptions to the non-taxation of the conduit income of Australian companies arise from the taxation of foreign source interest, royalties and portfolio dividends, and controlled foreign companies rules that in effect tax returns from the non-business investments of offshore subsidiaries. These exceptions limit opportunities for residents to defer taxation of the returns to their savings.

For Australian managed funds, though, the situation is less satisfactory. Managed funds established as trusts are currently treated on a flow-through basis for tax purposes, with some exceptions. As a consequence, the tax system should be largely neutral in its treatment of savings invested directly or indirectly through an Australian managed fund.

However, in practice, the taxation of Australian managed funds is more complex. Firstly, it is governed by a mix of trust law and tax law concepts. Secondly, there is a reliance on both case law and statutory rules. These complicating factors have given rise to uncertain tax outcomes.

In particular, considerable uncertainty remains around the treatment of investments offshore or cross-border dealings. As submissions indicate, this largely arises from ambiguity around the meaning of 'Australian source'. For example, reliance on common law can result in income being given an Australian source merely because a contract is executed in Australia, notwithstanding that the contract concerns non-Australian assets and non-resident owners. In some cases, issues also arise around whether having fund-related services performed in Australia gives rise to Australian residency or a permanent establishment in Australia.

### **Finding**

Current taxation arrangements for Australian managed funds create uncertainty around the treatment of conduit income, reducing the competitiveness of Australian managers of global savings.

### **Improving the treatment of foreign income**

Source and residence can be nebulous concepts, which make improving existing arrangements challenging. There is also a risk that any reforms to current arrangements may reduce the taxation of resident savings or profits of non-residents from Australian operations (where it is desirable that those profits be taxed).

These difficulties notwithstanding, the existing tax treatment of managed funds and related entities should be improved to provide greater certainty and minimise the risk of conduit income being taxed. As reforms will raise complex and technical issues, the details of these reforms require separate consideration.

### **Recommendation 35:**

Taxation arrangements applying to Australian managed funds and related services should be improved to provide greater certainty that conduit income will not be subject to Australian tax.

## B2. The treatment of business entities and their owners

### Key points

In Australia, partnerships and, to a significant degree, trusts are taxed on a flow-through basis. While this remains broadly appropriate, the general trust tax rules are complex and give rise to uncertainty. Accordingly, those rules should be rewritten and updated.

Companies are taxed as separate entities from their shareholders, but the imputation system avoids the double taxation of corporate profits. As dividend imputation still provides a number of benefits, including improved neutrality around financing and entity choices, and also has integrity benefits, it should be retained in the short to medium term.

The benefits of dividend imputation will, however, decline as Australia becomes more integrated into the global economy. Therefore, for the longer term, consideration should be given to alternatives to imputation as part of a broad reconsideration of company income tax arrangements.

To preserve the integrity benefits and integration outcomes of dividend imputation, imputation credits should continue to be provided only for Australian company income tax paid. Likewise, dividend streaming and franking credit trading practices should, in general, continue to be prohibited.

As part of closer economic relations between Australia and New Zealand, consideration could be given to the appropriate degree of harmonisation of business income tax arrangements between the two countries. Bilateral mutual recognition of imputation credits would be one element of this broad examination.

### B2-1 Approaches to taxing the income of business entities and their owners

The organisational forms or entities used for business activities depend on a country's legal arrangements and commercial practices. In Australia, businesses operate through companies, general and limited partnerships, and different types of trusts, as well as directly by individuals as sole traders.

Each of these entity types has advantages and disadvantages. For example, the limited liability of companies and their governance arrangements may make them better suited to conducting risky activities. Trusts, which separate legal and beneficial ownership, offer the benefits of asset protection. Operating as a sole trader is simpler than operating through a separate entity, reducing legal and accounting costs.

Income tax can apply to both the owners of a business and the business entity itself (except in the case of sole traders). This raises the prospect of double taxation, which may give rise to

high effective rates of tax. However, in some cases, even where income tax is paid at the owner and business levels, the total income tax paid may be less than if the business was operated by a sole proprietor subject to personal income tax only.

Where double taxation is seen to be undesirable, it can be dealt with in a number of ways, including by flow-through treatment (where the income of the entity is attributed annually to the owners), taxing the owners only on distributions received and on changes in the value of the business, and taxing both the owners and the business separately but in an integrated way. These approaches can also be combined; for example, a flow-through approach can be combined with entity taxation in certain circumstances.

If tax outcomes were the same regardless of the choice of business entity, the tax system would allow businesses to adopt organisational forms that are commercially preferred. While estimating the economic cost of inconsistent tax treatments of business entities is difficult, Gordon and MacKie-Mason (1997) found that taxes do affect the choice of organisational form, though non-tax factors dominate. There is also evidence that reductions in company income tax rates cause income to shift to the corporate sector (de Mooij & Ederveen 2008).

Flow-through treatment has considerable advantages in achieving outcomes consistent with a personal income tax system based on a progressive rate scale. However, there are situations where separate entity treatment may be more practical — in particular, for large businesses where ownership rights are frequently traded. Also, where such businesses are conducted through a company owned by non-residents, there are constraints on Australia's ability to tax the profits of the company other than on a separate entity basis.

Other features of the tax system may also affect how different entities should be taxed. For example, concerns over tax losses arising from mismeasurement of business income (which may occur where capital expenditures are immediately deducted) may justify imposing limits on loss flow through (see Section B1 Company and other investment taxes).

Commercial practice and needs, along with the non-tax legal and regulatory environments, are also relevant in considering the appropriate tax arrangements for different entity types. For example, in Australia, unit trusts have been the entity type most commonly used for managed investment vehicles, whereas in other countries companies may also be used. The nature of managed investment vehicles, which invest the savings of investors with very different tax profiles into domestic and foreign assets, places a premium on certain tax features, such as a flow-through treatment and certainty in tax outcomes.

### Principles

Income tax arrangements for different types of business entity and their owners should be broadly consistent to limit biases in choice of business structure, while taking account of diverse circumstances and requirements.

## Relationship between company and personal income tax

The difficulties associated with taxing large and complex companies under a flow-through approach mean that companies are typically taxed separately from their owners (shareholders). As shareholders are also taxed on company profits when received as

dividends (or as capital gains), an issue arises as to how the company and personal income tax systems interact.

Where the income taxation of companies and shareholders is not integrated (often referred to as a ‘classical’ company income tax), company profits are taxed once at the company level and then again in the hands of shareholders through personal income tax.

A classical company income tax system, by favouring unincorporated businesses, can bias individual choices around how a business is structured. It can also affect the allocation of activity between the corporate and unincorporated sectors, in turn potentially affecting overall investment allocation. And it can affect choices by individuals about investing their savings in shares. Classical company income tax systems may also distort company level financing and distribution decisions, encouraging the use of debt over equity and the retention rather than distribution of company profits.

The use of debt can give rise to a tax-induced bias in financing decisions because profits taken as interest are not taxed at the company level. This bias can give rise to non-tax costs, although this may not always be the case. For example, if the owner of a company – whether an individual owner of a small company or a multinational company with its subsidiary – is the sole provider of capital, a degree of integration can be achieved through contributing capital to the business primarily as debt, with few non-tax costs. However, for companies with more diversified sources of capital, the tax bias towards debt may result in excessive leverage, which can give rise to significant non-tax costs such as the increased risk of financial distress.

It is the potential biases arising from classical company income tax systems that make a case for shareholder tax relief. That relief can be implemented at either the company or shareholder level, or both (see Table B2-1).

**Table B2-1: Types of shareholder tax relief**

Company level		Shareholder level	
Type of relief	Description	Type of relief	Description
Dividend deduction	A full or partial deduction for distributed profits. (Akin to the approach taken with interest.)	Dividend exclusion	Proportion of dividend is excluded from taxation.
Credit	A full or partial credit to the company for distributed profits.	Credit	A full or partial credit for dividends received.
Reduced rate	Company income tax rate reduced.	Dividend imputation	A full or partial credit for dividends received to the extent company income tax was paid.
Expenditure tax	Deduction for normal return to capital. (Akin to the approach taken with interest.)	Reduced rate	Reduced tax rate for dividends received.
		Allowance for shareholder equity	Deemed normal return on shareholding excluded from taxation.

A high degree of integration can be achieved by providing shareholders with a credit (in full or part) for company income tax paid, as under dividend imputation. A semi-integrated or semi-classical approach would see tax relief provided to shareholders through other means; for example, through providing a tax credit not related to actual company income tax paid,

taxing dividends at a low rate, or having partial or full exemption of dividends from tax. Alternatively, relief could be provided at the company level by reducing company income tax in a number of ways.

More radically, expenditure tax approaches at either the company level (such as an allowance for corporate equity) or the shareholder level (an allowance for shareholder equity) could be adopted.<sup>12</sup>

### **The effects of providing shareholder-level tax relief**

There are three broad views about the effects of providing shareholder-level tax relief, and the extent of relief that is appropriate: the 'new view', the 'traditional view' and an 'open economy view'. These views are not mutually exclusive, and each can be relevant for some firms and may vary over time with changes in economic conditions. A wide range of largely non-Australian empirical studies has provided mixed support for all three views.

The new view holds that in certain circumstances, and even in a closed economy, taxes on dividends may be irrelevant to a firm's investment decisions and to the choice between funding investments from retained earnings or debt. Under this view, the value of a company is equal to the present value of post-tax dividends. Shareholders are therefore indifferent as to whether they retain their earnings in a company or receive dividends. Introducing shareholder level tax relief may simply result in an increase in the market value of companies, providing windfall gains to existing shareholders, and have no impact on a company's cost of capital and, hence, its investment decisions.

The traditional view holds that dividend taxation does affect business choices. This can occur because newly established companies do not have retained earnings and have more difficulties accessing debt. A tax bias against raising new shareholder equity therefore creates a bias against start-ups. Shareholders may also have a preference for receiving company profits as dividends rather than capital gains, as regular dividend distributions may indicate the health of the company and can counteract suboptimal reinvestment of profits by company managers.

The open economy view takes account of the openness of the economy to international investment and capital, and the trend over time to more integrated international capital markets. As discussed in Section B1 Company and other investment taxes, for a small open economy where capital is perfectly mobile, the cost of capital for domestic companies is determined internationally. A source-based tax, such as the company income tax, increases the pre-tax return demanded by international investors and so increases a company's cost of capital.

In contrast, resident shareholder taxes do not increase or decrease the pre-tax return demanded by non-resident savers and therefore do not affect a company's cost of capital or its investment decisions. Shareholder tax relief would likewise not affect a company's cost of capital. However, taxes on dividends and capital gains could still affect residents' decisions about where to invest their savings.

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<sup>12</sup> These approaches are outlined in Australia's Future Tax System conference paper by Sørensen and Johnson (2010).

As noted in Section B1, despite the trend towards increased openness in trade and international capital mobility, Australia will continue to exhibit some characteristics of a closed economy. Thus insights about how taxes affect economic outcomes in both open and closed economies need to be taken into account.

While this discussion assumes that company profits arise from the investment of capital, profits may also represent a return to the efforts of the owners, for smaller companies in particular. For these profits, it is the combined company and shareholder level taxes that represent the tax on that return to labour. This must be taken into account when integrating the taxation of such companies and their owners.

### Principles

The interaction of the company and personal income tax systems should avoid introducing biases to company financing arrangements, other business decisions and the allocation of household savings. In doing so, an important consideration is the openness of the economy.

## B2–2 Current entity arrangements have strengths and weaknesses

### A high level of tax integration between entities and their owners

In Australia, companies are the most significant type of business entity in terms of net assets and net income. For the 2006–07 income year, there were 750,275 companies (of which 1 per cent were public companies); 355,345 partnerships and 272,535 trusts identified for income tax purposes. Just over one million individuals reported net business income in their tax returns, reflecting sole traders (ATO 2009).

Partnerships are generally taxed on a flow-through basis, so that each partner is taxed similarly to a sole trader. Generally, the income and losses of a partnership flow through to the partners in proportion to their interests in the partnership. Where a partner leaves a partnership, they are taken to dispose of their share in the underlying partnership assets. This can create some complexity due to the interaction of the capital gains tax and partnership rules.

Trusts can be used as an alternative structure for conducting business activities. Trusts are largely taxed on a flow-through basis, with the income of a trust allocated to its beneficiaries based on their 'present entitlements'. However, losses do not flow through to beneficiaries. Where there is income of the trust to which no beneficiary is presently entitled, it is taxed in the hands of the trustee at the top personal income tax rate plus the Medicare levy.

In contrast to the treatment of partnerships and trusts, companies are taxed separately from their shareholders.<sup>13</sup> Under the dividend imputation system introduced in 1987, resident companies are able to attach (frank) imputation credits to dividends paid to shareholders.

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<sup>13</sup> Limited partnerships, public trading trusts, widely held unit trusts that do not limit their activities to eligible investment businesses, and corporate unit trusts are also taxed like companies.

The imputation credits represent tax paid by the company on behalf of the shareholders. Resident shareholders receiving franked dividends are taxed on the dividend and the attached credit, but their liability is reduced by the amount of the credit. From 1 July 2000, excess imputation credits have been refundable for individuals, superannuation funds and charities.

### Some variation in tax outcomes according to type of entity

While the tax treatment of the entity and its owners is highly or fully integrated for all types of entity, in practice there is some variation in: how business income is taxed (with a more favourable treatment of capital gains and foreign source income for unincorporated entities), access to losses, and potential tax deferral benefits from retaining income in a company (see Table B2-2).

These variations can distort business choices, and encourage more complex structures than would otherwise be used.

**Table B2-2: Tax treatment of income attributable to individual resident owner**

	Sole trader, partnership	Trust	Company
Taxable income	Taxed at individual's personal rate.	Taxed at individual's personal rate.(a)	Taxed at individual's personal rate.(b)
Tax-preferred income	Tax preference retained.	Partial claw back as a capital gain (unless non-fixed trust).	Claw back occurs when taxed as an unfranked dividend.
Capital gains of entity	50 per cent of gain is taxed at individual's personal rate.	50 per cent of gain is taxed at individual's personal rate.	Taxed at individual's personal rate.(c)
Foreign source income	Taxed at individual's personal tax rate with a credit for foreign tax.	Taxed at individual's personal tax rate with a credit for foreign tax.	After foreign tax income taxed at individual's personal tax rate.
Losses	Can be used against other income.(d)	Quarantined in trust to be carried forward.	Quarantined in company to be carried forward.

(a) If there is trust income to which no beneficiary is presently entitled, it is taxed to the trustee at the top personal tax rate plus the Medicare levy.

(b) Retained profits taxed at 30 per cent, but taxed at individual's personal tax rate when distributed, with credit for company income tax paid.

(c) A tax concession broadly equivalent to the capital gains tax discount is provided to investors in listed investment companies.

(d) Subject to non-commercial loss provisions being satisfied.

Source: Treasury (2008).

### Trust tax rules are complex, uncertain and result in inappropriate outcomes

The general rules governing the taxation of trusts rely on a mix of trust law concepts (which mostly derive from case law) and tax law concepts (which derive from case law and statute). Differing views on key concepts, such as 'present entitlement', 'income of the trust estate' and 'share', create uncertain tax outcomes for taxpayers, increasing compliance and administration costs.

For example, there are differing views as to whether the income of the trust estate refers to net accounting profit, distributable or gross ordinary income, or whether it can vary according to the terms of the trust deed. In addition, the interaction between the income of the trust estate (which relates to present entitlement) and the net income of the trust (the basis for a beneficiary's tax liability) can be problematic; for example, when it comes to the treatment of capital gains derived through a trust. Recent court cases have also given rise to uncertainty around whether income retains its character as it flows through a trust.

**Findings**

Partnerships and, to a significant degree, trusts are taxed on a flow-through basis, which can achieve a high degree of integration. Although companies are taxed on a separate entity basis, a similar degree of integration is achieved through the imputation system. There is, however, variation in how some types of income are taxed through different entities.

Current income tax rules applying to trusts are complex and uncertain.

**Ways of improving trust rules**

To reduce complexity and uncertainty around their application, the general trust tax rules should be updated and rewritten. While the trust tax rules have been examined recently by the Board of Taxation, that review focused specifically on how the rules applied to managed investment trusts rather than trusts in general (Board of Taxation 2010).

**Recommendation 36:**

The current trust rules should be updated and rewritten to reduce complexity and uncertainty around their application.

**B2–3 The future of dividend imputation****International trend away from imputation**

Australia and New Zealand are now the only two OECD countries to operate dividend imputation systems.

Countries that have abandoned dividend imputation systems include the United Kingdom (in 1999), Germany (in 2001), Finland (in 2005) and Norway (in 2006). While the move away from imputation for European countries can be partly explained by European Union legal issues, the trend has also been evident in Asian countries. Both Singapore (in 2003) and Malaysia (in 2008) have abolished their imputation systems.

Notwithstanding the move away from imputation, there has been no clear trend to reduce or remove shareholder level tax relief (see Table B2–3). The United States, whose federal company income tax rate has remained at 35 per cent since 1993, introduced dividend tax relief in 2003. While some countries that have low company income tax rates (such as Ireland and Switzerland) also have classical company income tax systems, other countries exempt resident shareholders from further tax (for example, Singapore and Hong Kong).

**Table B2–3: International approaches to shareholder and company interactions**

	Dividend received by resident from domestic company	Dividend received by resident from foreign company
New Zealand	Operates imputation system. Imputation credits are not refundable.	Taxed at shareholder's marginal tax rate, imputation credits not available.
United Kingdom	Dividend tax credit provided. Tax rates on dividends are lower than tax rates on other income.	Same treatment for foreign dividends.
United States	'Qualified' dividends taxed at 15% for high rate taxpayers; 0% for low rate taxpayers.(a)	Same treatment for foreign dividends if paid from a company resident in a country with which the US has a comprehensive tax treaty.
Germany	Substantial shareholders (interest greater than 25%) taxed on 60% of dividends at marginal rates (only 60% of expenses deductible). Other shareholders subject to final withholding tax of 26.38% on gross dividends.	Same treatment for foreign dividends.
Hong Kong	Exempt.	Same treatment for foreign dividends.
Singapore	Exempt.	Same treatment for foreign dividends.
Ireland	Classical taxation — taxed at shareholder's marginal tax rate without credit for company income tax paid.	Same treatment for foreign dividends.

(a) These arrangements are legally due to expire on 31 December 2010, when, absent further legislative changes, dividends will be taxed at normal marginal rates.

Source: Treasury.

Most developed countries fall in between the extremes of classical and full exemption systems, providing partial dividend exemption, partial tax credit, lower rates of tax for dividends, or a combination of these. Unlike dividend imputation, these approaches do not depend on company income tax having been paid on the profits from which the dividend is paid.

More radical forms of shareholder tax relief have been adopted in Belgium and Norway. Belgium operates a classical tax system but avoids double taxation largely by applying a business level expenditure tax — the allowance for *corporate* equity. Norway provides shareholder tax relief through an allowance for *shareholder* equity. This is similar to the allowance for corporate equity, except that relief is provided at the shareholder rather than the company level.

Companies are not always taxed as separate entities. For example, the United States operates a special regime for 'S corporations', which are legally companies but taxed as flow-through entities if certain conditions are met. The United States also operates a 'check the box' regime, under which a limited liability company that is not publicly traded can elect for either partnership or company treatment.

While the Australian and New Zealand imputation systems do not provide tax relief for dividends received from foreign companies, many other countries provide equal treatment for dividends received from domestic and foreign companies. For example, a United States taxpayer receiving a dividend from an Australian company would receive the same shareholder relief — a reduced tax rate on that dividend — as for a dividend received from a United States company.

### Dividend imputation provides benefits

Australia's imputation system provides a more neutral treatment of incorporated and unincorporated domestic businesses and has less impact on company financing and

distribution choices than the classical company income tax arrangements that applied before dividend imputation was introduced in 1987.

Dividend imputation may also encourage domestic business investment by reducing the cost of capital for domestically owned companies. This depends on the extent to which domestic rather than foreign providers of capital set the cost of capital for these companies. To the extent that domestic providers set the cost of capital, imputation may bias Australian companies owned by residents towards investing in Australia rather than overseas.

### Dividend imputation and the cost of capital

In general, a company will only make an investment where the expected return on that investment at least covers the rate of return required by the providers of the company's capital, both debt and equity. In a closed economy, it could be expected that imputation would reduce the cost of capital, at least for new equity. However, where an economy is open to foreign capital and such capital is readily available, the cost of capital will be influenced by international capital markets.

Imputation is likely to have a more positive effect in reducing the cost of capital for smaller and unlisted Australian companies, particularly when they are starting up or raising new equity. These companies typically have more limited or indirect access to international capital and, therefore, a higher reliance on residents' savings. However, although they may not have direct access to foreign capital, the cost of capital for larger firms that do have access will also influence that of smaller firms. Hence, even for smaller and unlisted Australian companies, international capital markets matter.

One way to gauge the impact of imputation on the cost of capital for larger, listed companies is through studies of the market value of imputation credits (see Table B2–4). While these studies report varying estimates, taken together they support the conclusion that imputation has a real but muted impact on the cost of capital for listed companies, and that the availability of foreign equity capital influences the cost of capital and market valuation of listed Australian companies.

**Table B2–4: Empirical estimates of the value of distributed franking credits**

Study	Method	Study period	Estimated value of distributed credits (cents in dollar)
Cannavan, Finn and Gray 2002	Options analysis(a)	1994–1999	≈ 50 (pre-45 day rule(b))
			≈ 0 (post-45 day rule(b))
Hathaway and Officer 2004	Dividend drop-off(c)	1986–2004	50
		Post-2000	60
Beggs and Skeels 2006	Dividend drop-off(c)	1986–2004	57 (2001–04)
Strategic Finance Group 2007	Dividend drop-off(c)	1998–2006	20–40

(a) The value of the imputation credit is inferred from the relative prices of futures contracts and the individual stocks on which they are based.

(b) The 45 day rule requires that ordinary shares must be held for at least 45 days around the date of dividend entitlement otherwise the shareholder is not entitled to any imputation credits. The shares must be held 'at risk' so if the shareholder removes a substantial part of the price risk (for example, through hedging), imputation credits may be disallowed.

(c) The value of the imputation credit is inferred from the amount by which the price of a share changes when it goes ex-dividend.

Source: Australian Energy Regulator (2008).

Table B2–4 shows the market valuation of one dollar of imputation credits distributed by listed companies. By way of comparison, such studies typically find that one dollar of distributed cash is valued at 80 cents in the dollar (Australian Energy Regulator 2008). That the estimated values for imputation credits are less than for cash suggests that imputation has less of a beneficial impact on domestic investment than could be assumed, but is more relevant than an application of a simple open economy perspective would imply.

The study by Cannavan, Finn and Gray (2004) estimates that the market value of imputation credits was reduced to zero when rules preventing franking credit trading (the '45 day rule') were introduced. These rules prevent non-resident shareholders from effectively obtaining a benefit from imputation credits by selling them to resident shareholders who can use them. The fall in the value of imputation credits with the introduction of the 45 day rule (which reduced the benefits of franking to non-residents) is consistent with an open economy perspective under which international capital markets set the cost of capital and value of shares for Australian companies.

Another way of testing the impact of imputation credits on the cost of capital for Australian companies is to look at survey evidence about how companies make decisions. A 2004 survey of Australian listed companies found that only 13 of the 77 companies that responded to the survey made adjustments for imputation credits in project evaluation, including in respect of company estimates of their cost of capital (Truong, Partington & Peat 2005). Only three respondents attached a value of more than 50 per cent to imputation credits.

For those companies that did not take account of imputation credits in their investment decision-making, reasons included: difficulties in setting an appropriate tax credit value for all shareholders; that the value of imputation credits was already factored into the share price; and irrelevance to non-resident shareholders.

### **Dual-listed companies**

Differences in the valuation of the Australian and non-Australian companies in a dual-listed company structure may also reflect the impact of imputation, and may suggest that imputation reduces the cost of capital for Australian companies. For example, Bedi, Richards and Tennant (2003) showed that for BHP-Billiton, a dual-listed company, the Australian shares traded at a 5 to 10 per cent premium to the United Kingdom shares. Such a premium may suggest that the market does value imputation credits.

However, the evidence is not clear cut. Not all dual-listed companies have traded at a premium on the Australian arm. Empirical studies have struggled to explain the observed long-term premiums for dual-listed companies, even taking account of tax factors. Further, dual-listed structures in effect allow for dividend streaming, and so may not provide conclusive evidence that imputation credits are generally valued.

### **Dividend imputation provides integrity benefits**

Dividend imputation also provides integrity benefits. For Australian companies with largely resident shareholders, company income tax acts as a prepayment of the personal income tax liabilities of shareholders on future dividends. The benefit to companies and their shareholders of avoiding or deferring company income tax is therefore reduced. This can increase company income tax revenues and reduce the need for anti-avoidance rules in general.

Tax administration and compliance costs are also reduced as companies spend fewer resources on trying to minimise tax paid. There is anecdotal evidence that some Australian companies bring forward tax obligations and eschew avoidance activities to generate franking credits. This appears particularly true of companies with a history of paying fully franked dividends.

For companies with foreign operations and a significant proportion of resident shareholders, imputation provides an incentive to shift foreign profits into Australia. This allows them to pay dividends from creditable Australian company income tax rather than non-creditable foreign tax. Similarly, imputation discourages domestically owned companies from shifting profits offshore.

The integrity benefits of imputation may partly explain why Australia's company income tax collections are high compared to other countries (see Section B1 Company and other investment taxes). While evidence of these integrity benefits is largely anecdotal, a recent quantitative cross-country study estimated that the presence of a dividend imputation system in a country gave rise to increased company income tax (Markle & Shackelford 2009).

The revenue outcomes discussed above reflect changes in gross company income tax paid. However, in looking at the benefits of imputation it is also necessary to consider the net gain to revenue. As increased company income tax payments generate more imputation credits that in turn reduce personal income tax collections, the net gain to revenue from imputation will be less than the gross gain. The net gain to the revenue from the integrity benefits includes:

- the time value of bringing forward tax from the personal to the company level;
- the absolute gain arising when imputation credits generated from the gross company income tax revenue gain are wasted (for example, because some shareholders are non-residents); and
- the revenue gained from taxable income increasing as foreign tax expenses are reduced (as Australian multinationals allocate more profits to Australia).

In considering the overall efficiency of the tax system, the net revenue gain from imputation is only of benefit if it is a relatively efficient source of revenue. It is difficult to assess whether this is the case, though the revenue and national income gains from encouraging the minimisation of foreign taxes are beneficial.

### Finding

Dividend imputation provides a number of benefits to Australia, including improved neutrality around financing and entity choices. It also has integrity benefits that have allowed for fewer anti-avoidance rules.

## Dividend imputation may create biases

### Biases from the non-credibility of foreign taxes

Under dividend imputation, resident shareholders in an Australian company that invests offshore generally do not receive imputation credits on dividends paid out of the profits from that investment. Dividends and capital gains from such investments are generally exempt from tax in the hands of Australian companies, and imputation credits are not provided for any foreign company income or withholding tax paid.

As imputation credits are not permitted for foreign company income tax and other taxes such as foreign dividend withholding tax, resident shareholders in an Australian company receive the equivalent of a deduction, rather than a credit, for foreign taxes paid. Dividends paid out of net company profits (after deducting foreign taxes) are taxed in full without credit. The same is true for residents who hold shares in a foreign company, though they may receive a credit for foreign dividend withholding tax.

From the perspective of Australian companies, the non-credibility of foreign taxes may increase the required return for offshore investment, discouraging such investments and encouraging a domestically-orientated investment focus. From the perspective of Australian shareholders, the tax benefit of franked dividends may encourage them to invest more of their savings in Australian companies that invest domestically in preference to other Australian or foreign companies or other assets (a savings portfolio bias).

An assessment of the consequences of these tax biases depends on whether a more traditional view of dividend taxation is adopted or whether more weight is placed on the increasing openness of the economy (see Table B2–5). In practice, given the evidence on the effect of imputation on the cost of capital of Australian companies, the actual effects are likely to fall somewhere in between the consequences suggested under each perspective and to depend in part on firm-specific characteristics.

**Table B2–5: Biases created by the non-credibility of foreign taxes and their potential consequences**

Nature of potential bias	Consequences under traditional or new view	Open economy perspective
Bias against offshore investment by an Australian company	Cost of capital for an Australian company investing offshore may be increased, encouraging domestic over foreign investment.  Bias may be optimal from a national efficiency perspective.	Cost of capital for Australian company for investments offshore is unaffected, as it is determined by international capital markets.  Bias of no consequence to the allocation of investments between countries and, hence, the level of investment in Australia.
Portfolio bias against investment, by Australian resident or superannuation fund, of their savings in an internationally orientated Australian company or in a foreign company	Return to shareholder affected by company and shareholder-level taxes.  Bias in favour of investment of savings in domestically focused Australian companies, but the bias is reduced the lower are foreign taxes on the offshore investment. Depending on financial policies of a company, the bias may be reversed.	Return to shareholder affected by shareholder level tax.  Bias in favour of investment of savings in domestically focused Australian companies. Reduces gross inbound and outbound flows of capital; net capital flows remain unchanged.

### **According to the traditional or new view**

To the extent that the tax bias against offshore investment actually has an effect, it may be beneficial from a national perspective. This is because paying foreign tax does not benefit Australians. Rather, it reduces the net return to Australians of the offshore investment of domestic savings. In contrast, paying Australian company income tax on a domestic investment helps fund transfers and public services. By restricting imputation to Australian company income tax and not giving a credit for foreign taxes, Australian companies treat foreign tax as a cost, so aligning their private interests with the national interest.

One qualification to this national interest argument is that it assumes there are no potential spillover benefits from offshore investment by Australian companies. It also assumes that direct investment offshore is a substitute for, rather than a complement to, domestic investment, whereas there is evidence that for some industries or types of firm this is not always the case (Desai, Foley & Hines 2009).

The non-credibility of foreign taxes also gives rise to a potential portfolio bias for resident savers against owning shares in companies that invest offshore. However, whether there is actually a bias against holding shares in a foreign company or internationally focused Australian company depends on the level of foreign taxes applying to the company and its financial and distribution policies. Where the level of foreign taxes is low, and shareholder taxation is deferred, the bias against offshore investment may actually be reversed.

### **According to the open economy perspective**

These results do not hold to the extent that the cost of capital (in Australia and overseas) is set by international capital markets. In that case, resident shareholder tax relief has no impact on the firm's cost of capital. Hence, the non-credibility of foreign taxes does not give rise to a bias against offshore investment by Australian companies. The portfolio savings bias becomes more evident, however, as differences in company income taxes between countries are offset by differences in company profitability.

### **Biases from restricting imputation to shareholders of Australian companies**

Imputation is, for the most part, limited to Australian companies. Shareholdings in foreign companies, even those that conduct business in Australia and pay Australian company income tax, do not give rise to imputation credits. As well as creating the savings portfolio bias discussed above, this feature of the imputation system may discourage Australian companies from shifting their residence offshore.

The extent to which companies have an incentive to remain resident for tax purposes depends on the proportion of resident shareholders to total shareholders, and of domestic income to total income. As the proportion of non-resident shareholders or foreign income rise, the benefits of maintaining residence in Australia fall. For example, a resident entrepreneur with an internationally focused company could have an incentive to shift the residence of both themselves and their company offshore.

An exception arises in the case of Australian shareholdings in New Zealand companies with Australian operations. In this case, the New Zealand company is able to provide imputation credits to Australian shareholders for Australian company income tax paid, in proportion to the shareholders' ownership of the company. The same applies in the case of New Zealand shareholders of an Australian company with New Zealand operations. This rule provides neutrality in company location decisions between Australia and New Zealand.

### Complex rules have been adopted in response to the biases

As different types of shareholders are taxed differently on their dividend income, the value they ascribe to imputation credits will vary. This sets up incentives for franked dividends to be paid to those shareholders that value them the most.

In particular, as non-resident shareholders cannot directly benefit from imputation credits (other than to avoid dividend withholding tax), there is an incentive for companies to stream unfranked dividends to non-residents and franked dividends to resident shareholders.

Non-residents who would otherwise receive franked dividends also have an incentive to enter into arrangements (franking credit trading) that see those dividends paid to resident taxpayers, in return receiving compensation in a tax-effective way for the loss of the cash dividend and for allowing the use of the imputation credit.

As a consequence of these incentives, the imputation system requires its own complex anti-avoidance rules to prevent dividend streaming and franking credit trading. These rules apply inconsistently; they do not prevent streaming through the use of dual-listed companies.

#### Finding

The benefits of dividend imputation have declined as the Australian economy has become more integrated into the global economy. In particular, benefits in relation to financing neutrality have fallen, while the bias for households to over-invest in certain domestic shares has increased. Furthermore, imputation has its own complex integrity rules.

## B2–4 Reform directions for dividend imputation

#### Recommendation 37:

Dividend imputation should be retained in the short to medium term, but for the longer term, consideration should be given to alternatives as part of a further consideration of company income tax arrangements.

#### Recommendation 38:

A flow-through entity regime for closely held companies and fixed trusts should not be adopted for now, but would merit further consideration if there is a move away from dividend imputation in the long run.

#### Recommendation 39:

While dividend imputation is retained, imputation credits should continue to be provided only for Australian company income tax. Dividend streaming and franking credit trading practices should, in general, continue to be prohibited.

#### Recommendation 40:

If increased integration of the Australian and New Zealand economies is desired, a broad examination of the appropriate degree of harmonisation of business income tax arrangements between Australia and New Zealand should be undertaken.

## Alternatives to dividend imputation should be considered for the future

Dividend imputation continues to deliver benefits for Australia, particularly for smaller firms and those operating in the more closed segments of the economy. However, a continuation of the trend of increased openness, rapid growth in cross-border investment flows and greater capital mobility will reduce the benefits of imputation in the longer term. Consideration therefore needs to be given to long-term reform options that provide a better fit with the global economy but which still retain the positive aspects of imputation (see Recommendation 37).

For a small, open economy that is increasingly integrated with international capital markets, providing tax relief only on dividends paid to resident shareholders will become less effective in reducing the cost of capital for companies (and hence of reduced benefit in encouraging investment) or in providing a neutral treatment of debt and equity. The bias for domestic savings to be invested in the shares of Australian companies will increase, limiting opportunities and increasing risk to households from poorly diversified savings portfolios.

Reform could involve switching tax relief from the double taxation of dividends from the shareholder level to the company level. Doing so would provide the same outcomes for resident shareholders as the current system, but would further reduce tax on non-resident shareholders. In effect, there would be a move to greater reliance on the taxation of residents' savings income and less reliance on source-based investment taxes. This switch would further encourage investment in Australia and reduce Australian companies' reliance on foreign debt. It would also reduce biases in the allocation of residents' savings.

To achieve such a switch, consideration could be given to a partial integration system that is common overseas, while at the same time reducing the company income tax rate. A more radical approach, which has greater potential gains but is largely untested overseas, would be a move towards a company or business level expenditure tax. This option for long-term reform is outlined in Section B1 Company and other investment taxes.

### A flow-through entity regime for closely held businesses

The Australian Government asked the Review to consider a proposal to allow small, closely-held companies and fixed trusts the option to effectively be treated as partnerships for tax purposes. Under this approach, income and losses of the company or trust would be assigned to shareholders and beneficiaries regardless of whether they were distributed. The proposal received mixed support in submissions.

The proposal has the potential to reduce the compliance burden for micro-enterprises, as the many sets of rules associated with the current separate entity treatment of companies and some elements of the treatment of trusts would not apply. For example, flow-through taxation would make redundant the deemed dividend rules relating to non-commercial loans from a company to shareholders. The proposal could also allow some multiple entity structures to be simplified.

Flow-through would also allow the tax losses of an entity to be transferred to its owners, who could then offset the losses against other income, rather than leaving the losses trapped in the company or trust. A flow-through regime could therefore also have the benefit of improving loss symmetry, a potentially useful policy outcome if measured tax losses correspond to economic losses (see Section B1).

While flow-through approaches to the taxation of business entities have general merit, flow-through entities could become yet another option for business to consider or another component of an even more complicated business structure. New rules would be required to determine eligibility for, and the consequences of, flow-through treatment, and transitions into and out of such arrangements. Where flow-through treatment is provided for businesses falling below a size threshold, the prospect of losing flow-through treatment could deter small businesses from expanding.

Experience with optional regimes suggests that they can significantly complicate the tax system while doing little to reduce compliance costs (see Section G5 Monitoring and reporting on the system). Research in the United States, where a number of company or company-like flow-through entities are available, has found that the income tax compliance costs of operating a flow-through vehicle are marginally greater than the costs for a normal company (under a classical company income tax) and around one-and-a-half times the costs of a general partnership (DeLuca et al. 2005).

While flow-through companies and related entities are extensively used in the United States, they were developed in the context of a system that at the time provided no credit at the shareholder level for company income tax paid. In Australia, dividend imputation provides reasonably effective integration between shareholders and companies, so the case for running multiple systems is weaker.

However, as part of any consideration of a long-term move away from dividend imputation, adoption of flow-through company and entity arrangements may be a useful means to provide appropriate outcomes for smaller businesses (see Recommendation 38).

### **Dividend imputation should retain its current features**

So long as dividend imputation is retained, pressures on how it operates will continue to increase as the economy becomes more open and cross-border investment flows grow. In this regard, and generally reflecting the long-standing concerns of the business community, submissions to the Review have proposed altering the current imputation system to provide increased recognition for foreign taxes or to permit dividend streaming.

The primary argument for these proposals is to reduce the imputation bias against offshore investment. However, as discussed, to the extent that there is a bias, it may be beneficial to Australia. The case for change, therefore, is problematic in general and current policy settings should remain in place (see Recommendation 39). In addition, the proposals raise further specific issues that are discussed below.

### **Providing a tax credit for foreign tax is problematic**

Submissions to the Review have proposed providing a credit for foreign investment taxes paid by Australian companies on the basis that this will remove impediments to Australian companies expanding overseas. Credits for foreign taxes could take the form of either an imputation credit for actual foreign company tax paid or a uniform credit that is not linked to actual foreign tax payments.

Since companies seeking to expand offshore would typically be larger and more mature, they should have better access to international capital than other businesses in the domestic economy. Providing imputation credits to resident shareholders for foreign tax paid would

not directly assist them in raising foreign capital and so could have limited impact on their cost of capital and their potential for offshore expansion. It would, however, increase resident shareholders' post tax returns from their savings.

This argument may not apply in all cases. For example, there may be small, newly formed internationally or regionally focused businesses that look to expand offshore relatively soon after starting up. If such companies have only a few owners, there could be an incentive for the owners to relocate both themselves and their companies offshore. This is because a change of residence could reduce the total Australian and foreign tax bill at the company and shareholder levels. Providing increased recognition of foreign company taxes could go some way to reducing or reversing these incentives.

Providing a credit for foreign taxes paid by an Australian multinational could also have the benefit of removing a bias that encourages households and superannuation funds to invest more in domestically-orientated Australian companies than they otherwise would. At the same time, for investors wanting greater exposure to investments in foreign countries, it would create a bias favouring investments in Australian multinationals over foreign companies.

However, providing credits for foreign taxes would reduce the integrity benefits of the imputation system. By extending imputation to foreign taxes, the incentive for Australian companies to pay Australian tax would be reduced. Similarly, domestically owned companies would have greater incentives to shift profits to low-tax foreign countries, putting additional pressure on rules to prevent international profit shifting.

### ***Providing a credit is difficult in practice***

If imputation credits were provided to resident shareholders for actual foreign company income and withholding taxes paid by Australian companies, there would be increased administration and compliance costs associated with identifying creditable foreign taxes. Companies would need to identify and potentially track foreign taxes paid by foreign subsidiaries. The Australian Taxation Office would also need to be able to verify those payments, which would be difficult.

Given these practical difficulties, imputation credits provided for foreign taxes would not be refundable. Companies and shareholders would be required to account separately for refundable and non-refundable imputation credits, further increasing complexity and compliance costs.

A potentially simpler alternative would be to provide a non-refundable tax credit for dividends paid to resident shareholders by Australian companies out of designated foreign income not subject to Australian company income tax. Companies already track foreign income under the conduit foreign income rules. However, in this case credits could be provided to resident shareholders for dividends paid out of foreign income not subject to foreign tax.

### **Tax harmonisation with New Zealand and the mutual recognition of imputation credits**

The merits of Australia and New Zealand recognising each other's imputation credits has been the subject of previous consideration by both governments, and has been proposed in submissions to the Review.

Mutual recognition of imputation credits would involve providing imputation credits for foreign taxes on a reciprocal rather than unilateral basis. Australian shareholders of Australian and New Zealand companies investing in New Zealand would be eligible to receive a credit for New Zealand company income tax paid. A similar arrangement would apply for New Zealand shareholders.

Mutual recognition would have the potential to improve the allocation of investments between the two countries, increasing productivity, and potentially reducing barriers to competition between Australian and New Zealand companies. It could also reduce incentives for firms to engage in profit shifting between Australia and New Zealand, probably to New Zealand's net benefit.

Some of the issues raised by bilateral mutual recognition are similar to those that would arise if Australia were unilaterally to increase recognition for foreign taxes. To the extent that the cost of capital for firms is set internationally, the benefits and costs of bilateral mutual recognition in respect of investment allocation would be reduced. Mutual recognition would also entail additional complexity and administration and compliance costs, though tax administration issues would be more manageable.

There is currently a significant imbalance in trans-Tasman investment. New Zealand direct and portfolio investments in Australia, as at 31 December 2008, totalled \$14.3 billion (\$4.5 billion and \$9.8 billion respectively). In contrast, Australian investment in New Zealand totalled \$36.2 billion (\$32.5 billion and \$3.7 billion respectively) (ABS 2008a). Hence, mutual recognition would impose higher revenue costs on Australia than on New Zealand. However, any imbalance in direct revenue costs is not of itself an argument against mutual recognition. Revenue costs do not necessarily represent transfers from Australia to New Zealand. They can also reflect reduced taxes imposed by Australia on the savings of its own residents (and vice versa).

The case for mutual recognition has also been raised in the context of developing closer economic relations between Australia and New Zealand. This is because mutual recognition could have a role in furthering broader policy objectives and achieving greater integration of the two economies.

If increased integration of the Australian and New Zealand economies is desired, the starting point for an assessment of the issues and possible benefits should be broader than just mutual recognition. Consideration would better start with a broader assessment of the appropriate degree of harmonisation of the two countries' business income tax arrangements (see Recommendation 40). That broader assessment would also take into account company income tax settings and related arrangements such as capital gains tax, the treatment of foreign source income, and the taxation of financial arrangements.

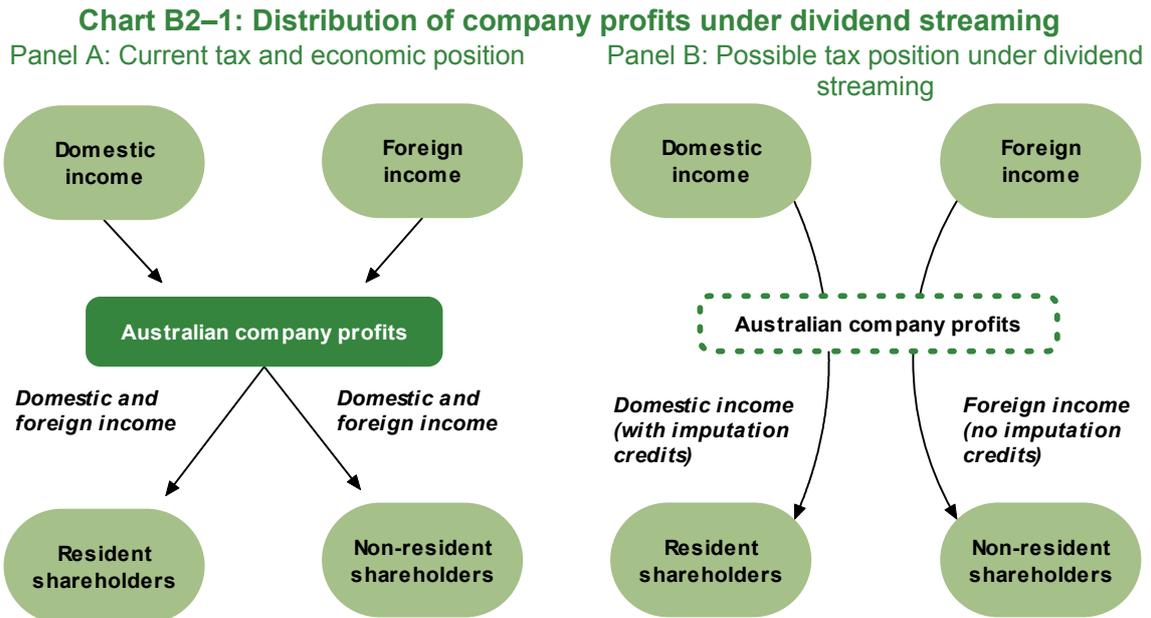
Mutual recognition would be one element of this broader examination, which could also take account of possible long-term reform directions in Australia.

### **Dividend streaming of foreign source income**

The current rules prevent dividend streaming; that is, the payment of franked dividends to those shareholders who benefit from them the most (typically residents) and unfranked dividends to other shareholders (typically non-residents). Submissions to the Review have proposed allowing the streaming of unfranked dividends, paid out of a company's foreign

source income, to non-resident shareholders. However, there are good reasons to prevent dividend streaming.

There are a number of variants of dividend streaming, but all would have the potential effect that a shareholder's tax interest in company profits would be different to their legal and economic interest. This would be inconsistent with the integration objectives of imputation. For tax purposes, non-resident shareholders would be assumed to have an interest in the company's foreign income ahead of its other income; whereas their economic and legal interest would typically be in both the domestic and foreign source income of the company (see Chart B2-1). A similar divergence would arise for resident shareholders.



Dividend streaming could reduce the tax burdens faced by resident or non-resident shareholders, but for those benefits to be realised, the company would need a mix of resident and non-resident shareholders and of (taxed) domestic source and (untaxed) foreign source income. To maximise the benefits of dividend streaming, companies would need to get the right proportions of resident and non-resident shareholders, and of domestic and foreign income.

Hence a small, rapidly expanding and domestically owned company seeking to invest offshore would not benefit unless it changed its ownership structure. Those companies best able to benefit from streaming – those that have a mix of resident and non-resident shareholders and investments – would be likely to have access to international capital and be less reliant on domestic financing. Hence, their cost of capital would more likely be set internationally, reducing the potential benefits from streaming.

By maximising, for any given amount of company income tax paid, the credits available to frank dividends to resident shareholders, dividend streaming would also reduce the incentives to pay company income tax. It would therefore reduce the integrity benefits of the current rules.

### ***Dividend streaming by foreign multinationals***

Another possible variant of dividend streaming would be to permit foreign multinationals with a secondary listing on the Australian stock exchange to stream the imputation credits from their Australian subsidiary to the resident shareholders in the parent company.

The benefits of doing so could be to encourage secondary listing on the Australian stock market by firms with significant operations in Australia, increasing demand for Australian financial services. Further, by increasing the degree of connection of foreign companies with Australia it could conceivably reduce any bias against investing in Australia stemming from its geographic isolation.

However, it is not clear that permitting dividend streaming in this way would have these effects, or that the tax-driven stock market activity generated would be worthwhile. In addition, under the current imputation system, a multinational with Australian shareholders and operations has an incentive to take up Australian (or New Zealand) residency. Permitting dividend streaming by foreign multinationals would remove this incentive.

The current imputation system encourages residents to over-allocate savings into domestically focused Australian companies, which may limit the scope for geographic risk diversification. Permitting streaming by foreign multinationals could offset this bias by encouraging Australians to own shares in these companies. However, in turn, the bias against investing savings in internationally focused companies (both Australian and foreign) would worsen.

## B3. Tax concessions for not-for-profit organisations

### Key points

Not-for-profit (NFP) organisations make a highly valued contribution to community wellbeing and receive government and community support for their activities.

Much of the support provided to the NFP sector comes from tax concessions, including income tax exemptions, GST credits and exemptions, capped exemptions from (or rebates of) fringe benefits tax, and tax deductible gifts.

- This system of tax concessions is complex, and does not fully reflect current community values about the merit and social worth of the activities it subsidises.

NFP organisations face inconsistent state and federal regulation, which may deter them from undertaking legitimate fundraising activities and may undermine public confidence in the sector.

The High Court of Australia's 2008 decision in the *Word Investments* case has significantly increased the scope for NFP organisations to undertake commercial activities.

- The income tax and GST concessions generally do not appear to violate the principle of competitive neutrality where NFP organisations operate in commercial markets. However, the fringe benefit tax concessions provide recipient organisations with a competitive advantage in labour markets.

Where NFP clubs operate large trading activities in the fields of gaming, catering, entertainment and hospitality, the rationale for exempting receipts from these activities from income tax on the basis of a direct connection with members is weakened.

These issues could be addressed through: the establishment of a national charities commission to monitor, regulate and provide advice to all NFP organisations; reconfiguring the FBT concessions to alleviate competitive neutrality concerns while retaining government support for the NFP sector; and better targeting the application of the mutuality principle.

### B3–1 Why tax concessions are available to NFP organisations

Not-for-profit (NFP) organisations make a highly valued contribution to community wellbeing in the areas of community and welfare service, religion, education, sport and recreation, environmental protection and animal welfare. The defining feature of NFP organisations is that they are constituted to distribute surpluses in accordance with their objectives, and are precluded from returning profits or surplus assets to members.

NFP organisations receive government and community support for their activities, in recognition that:

- NFP organisations supply goods and services with broad public benefits that may not otherwise be provided by private businesses. These benefits may be direct (such as providing legal advice to the homeless) or indirect (such as organising community sporting activities).
- NFP organisations are often more effective service providers than government or for-profit organisations, given their unique relationship with the community. An increasing number of traditionally government activities are being outsourced to NFP organisations.
- The activities of NFP organisations often supplement, or complement, existing government programs.

Much of the support provided to the NFP sector is delivered through tax concessions. These concessions are an important and longstanding source of financial support for the NFP sector, and assist NFP organisations to further their philanthropic activities and objectives.

### Principle

Tax concessions for NFP organisations should be simple and transparent, reflect community needs and values, and encourage activities that provide broad public benefits. They should not undermine competitive neutrality where NFP organisations operate in commercial markets.

## B3–2 Existing NFP tax concessions and regulatory arrangements are complex

### Tax concessions

The tax concessions available to NFP organisations include income tax exemptions, a higher GST registration threshold, the ability to make supplies GST-free in certain circumstances, GST input credits, capped exemptions from (or rebates of) fringe benefits tax (FBT), and the ability to receive tax deductible gifts (see Table B3–1). Not all NFP organisations receive all concessions – generally the concessions depend on the particular public benefit purposes of the organisation.

**Table B3.1: Main tax concessions for major types of NFP organisations<sup>(a)</sup>**

	Value (\$m) (2008–09)	Charities	Public benevolent institutions(b) and health promotion charities	Deductible gift recipients	NFP and public hospitals, and public ambulance services
Income tax exemption(c)(d)	*	Yes	Yes	–	Yes
GST concessions	*	Yes	Yes	Yes	Charities only
FBT exemption (\$17,000)	260	–	–	–	Yes
FBT exemption (\$30,000)	715	–	Yes	–	–
FBT rebate(e)	20	Charitable institutions only	–	–	–
Deductible gifts	1,080	–	Yes	Yes	Yes

(a) Entities may have more than one status (for example, a charity could also be a deductible gift recipient).

(b) There are over 11,000 public benevolent institutions in Australia, including organisations such as: Anglicare Australia Inc; Australian Federation of Disability Organisations Ltd; Australian Red Cross Society; Parents, Families and Friends of Lesbians and Gays Inc; Refugee Council of Australia Inc; and Society of St Vincent de Paul Pty Ltd.

(c) Many NFP organisations are taxable, but are entitled to special rules for calculating taxable income and lodging income tax returns and are able to access special rates of tax.

(d) Income tax exempt entities that do not meet the broad definition of a NFP organisation, such as municipal corporations, local governing bodies, constitutionally protected funds, and public authorities constituted under Australian law, are not discussed in this section.

(e) Certain non-government NFP organisations are eligible for this concession.

\* The value of the concession cannot be quantified.

Sources: ATO (2007) and Treasury (2009).

This system of tax concessions is unnecessarily complex. At a federal and state level, the concessions are set out in at least 40 separate pieces of legislation, administered by 19 separate agencies (National Roundtable of Nonprofit Organisations 2007). This imposes significant compliance costs on NFP organisations.

The complexity of the concessions is exacerbated by their outdated application. For example, the classes of NFP organisation eligible for public benevolent institution status are based on the preamble of the *Charitable Uses Act 1601* ('Statute of Elizabeth'). The narrow interpretation of 'benevolence' derived from the Statute of Elizabeth excludes activities that have evolved to be valued by the community, such as animal welfare, international aid and development, and the promotion of human rights. The current hierarchy of concessions does not fully reflect current community views about the merit and social worth of different activities, or respond flexibly to special circumstances (such as natural disasters).

## Regulation

NFP organisations also face significant complexity in relation to their regulatory arrangements, particularly where they operate in more than one jurisdiction. Submissions to the Review have expressed concern that inconsistencies between state and federal regulations may deter NFP organisations from undertaking legitimate fundraising activities, and may undermine public confidence in the sector.

## Findings

The tax concessions available to NFP organisations are complex and do not fully reflect community preferences.

The regulatory framework for NFP organisations is inconsistent and opaque.

## Competitive neutrality

In 2008, the High Court of Australia's decision in *Commissioner of Taxation of the Commonwealth of Australia v Word Investments Limited* [2008] HCA 55 found that a commercial business that directs its profits to charities is eligible for endorsement as a tax concession charity. The decision means that NFP organisations now have a significantly larger scope to undertake commercial activities on a concessionally taxed basis.

The Review has considered the three main tax concessions (income tax, GST and FBT) from a competitive neutrality perspective.

### Income tax

Income tax exemptions enable many NFP organisations to retain untaxed profits for further investment, while for-profit organisations must invest from after-tax profits. This is the main advantage conferred on eligible NFP organisations by the income tax exemption.

Some submissions have expressed concern that income tax concessions may undermine the efficient allocation of economic resources. Economic theory provides a conceptual framework for assessing these concerns through Samuelson's invariant valuations theorem (see Box B3-1). The application of the theorem relies on a range of assumptions, including that NFP organisations seek to maximise profits. Although this may not be true of all NFP organisations, it is a reasonable assumption given their purposes.

In practice, the provision of tax concessions to NFP organisations is likely to result in an over-allocation of resources to the NFP sector. However, this bias is offset to some extent by the fact that the philanthropic activities undertaken by NFP organisations provide public benefits.

**Box B3–1: Samuelson’s invariant valuations theorem**

Samuelson’s invariant valuations theorem (1964) provides a conceptual framework for assessing the impact of the income tax exemption for NFP organisations on resource allocation. The application of the theorem to NFP organisations assumes that these organisations seek to maximise profits in the same way as other businesses; however, this may not be true of all NFP organisations.

The theorem states that where taxable income is the same as economic income, the discounted present value of a stream of cash flows is independent of the tax rate. In other words, the maximum amount that an individual is prepared to pay for an asset is independent of the tax rate.

Consequently, a tax on economic income will not create arbitrage opportunities between taxpayers on different rates and will not affect either relative or absolute asset values. Accordingly, it will not distort the composition or level of investment in the economy. Thus, providing that economic income is taxed, the existence of concessionally taxed NFP organisations should not distort asset allocation (or the level of investment) in the economy.

However, as the current income tax base differs considerably from economic income, and as the tax concessions for NFP organisations are linked to particular activities regarded as providing a public benefit, the concessions are likely to distort investment decisions. However, to the extent that the concessions address a market failure (that is, the under-provision of social services), they may still increase wellbeing.

In relation to pricing, NFP organisations, like for-profit organisations, will seek to maximise their profits in support of their philanthropic activities. Accordingly, it appears that the income tax exemption does not provide an incentive for NFP organisations to undercut the prices of their for-profit competitors; rather, NFP organisations follow the same pricing policies as their competitors to maximise their profits.

**Finding**

The NFP income tax concessions do not generally violate the principle of competitive neutrality where NFP organisations operate in commercial markets.

**Mutuality**

A range of NFP organisations are clubs that are not income tax exempt, because they do not qualify as operating for a tax exempt purpose. However, these clubs are subject to the mutuality principle, which is based on the notion that a person cannot make a profit from selling to themselves.

As a result, where a taxable NFP club provides services for a charge to its members, it is not considered to derive income from those members. The result is that mutual receipts are excluded from the club’s calculation of its income tax liability. Unlike the gift deductibility provisions, which require deductible gift recipients to use their income in accordance with particular philanthropic objectives, NFP clubs that benefit from the mutuality principle are free to spend their mutual receipts as they wish (subject to their objects that typically do not involve philanthropic purposes).

In Australia, many small clubs benefit from the mutuality principle, including community organisations (such as vintage car clubs), professional associations, and strata title bodies corporate. In these cases, there is usually a clear and direct nexus between the mutual purpose of the club and the services received by members.

The principle also benefits a number of very large NFP clubs with many members and high levels of turnover, which engage in trading activities in direct competition with the hotel and restaurant industries. Any mutual receipts these clubs receive, including membership fees and restaurant, bar and gambling revenues (which account for most of the total income of hospitality clubs), are tax exempt. By contrast, hotels and restaurants are assessed on all of the income they receive.

In the case of clubs with large trading activities in the fields of gaming, catering, entertainment and hospitality, a practice has emerged to establish wide membership at a nominal charge for patrons whose only substantive activities at the club are as customers of the trading activity (whether personally or by bringing 'guests'). It is not clear that the wider community should entirely forgo tax on all of these profits, although some concession could be retained, particularly to support smaller clubs.

### Finding

Where NFP clubs operate large trading activities in the fields of gaming, catering, entertainment and hospitality, the rationale for exempting receipts from these activities from income tax on the basis of a direct connection with members is weakened.

### GST

The GST concessions provided to NFP organisations are unlikely to impact on competitive neutrality. Unlike income tax exemptions, the commercial activities of NFP organisations are taxable under the GST legislation, unless an explicit concession applies.

### Finding

The NFP GST concessions do not violate the principle of competitive neutrality where NFP organisations operate in commercial markets.

### Fringe benefits tax

In effect, labour is taxed at a reduced rate for NFP organisations that are eligible for FBT concessions. These organisations can offer benefits such as mortgage repayments, laptop computers, and motor vehicle leases tax free, or at a reduced rate — concessions that are unavailable to their for-profit competitors. Consequently, NFP organisations have an advantage in attracting staff in labour markets, as they can afford to pay the market wage at a lower cost.

This bias is particularly problematic in the hospitals sector, where nursing shortages are an ongoing concern. Modelling provided to the Review<sup>14</sup> suggests that the current configuration of the FBT concessions is contributing to wage inflation across the sector. It is estimated that

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14 Modelling undertaken by Access Economics.

the concessions provide nurses in public and NFP hospitals with around \$2,800 in additional after-tax remuneration (approximately 6 per cent) compared to their counterparts in commercial hospitals, despite the similar nature of their work. Further, the concessions are not helping to increase the overall pool of nursing staff.

The impact of the FBT concessions is less clear where no direct for-profit competition exists (for example, in the provision of health services in remote areas). The removal of FBT concessions in these cases may make it difficult for NFP organisations to attract appropriately qualified staff, which may result in the downsizing or closure of programs.

### Finding

The NFP FBT concessions provide recipient organisations with a competitive advantage in labour markets, by enabling them to pay the market wage at a lower cost.

## B3–3 Reform directions

### Recommendation 41:

Consistent with the recommendations of previous inquiries, a national charities commission should be established to monitor, regulate and provide advice to all not-for-profit (NFP) organisations (including private ancillary funds). The charities commission should be tasked with streamlining the NFP tax concessions (including the application process for gift deductibility), and modernising and codifying the definition of a charity.

### Recommendation 42:

Categories of NFP organisations that currently receive income tax or GST concessions should retain these concessions. NFP organisations should be permitted to apply their income tax concessions to their commercial activities.

### Recommendation 43:

NFP FBT concessions should be reconfigured.

- (a) The capped concessions should be phased out over ten years. In the transition period, the value of the caps would gradually be reduced. Reportable fringe benefits for affected employees (that is, those benefits that are readily valued and attributed) would be exempt from tax up to the relevant cap, and taxed at the employee's marginal tax rate above the cap. The market value of these benefits would be taken into account for transfer payment purposes. Non-reportable fringe benefits would be taxable for NFP employers.
- (b) The FBT concessions should be replaced with direct government funding, to be administered by relevant Commonwealth portfolio agencies or the charities commission. All NFP organisations eligible for tax concessions should be able to apply to the relevant body for funding for specific projects or for assistance with the costs of recruiting specialist staff.

#### **Recommendation 44:**

Simple and efficient tax arrangements should be established for clubs with large trading activities in the fields of gaming, catering, entertainment and hospitality. One option is to apply a concessional rate of tax to total net income from these activities above a high threshold. For clubs below the threshold, no tax would be applied to income from these activities.

### **Establish a national charities commission**

Over the past two decades, the NFP sector has been the focus of a large number of reviews, which have consistently recommended the establishment of an independent national charities commission to address the complexity of the tax and regulatory arrangements for the NFP sector.<sup>15</sup>

The Review supports this recommendation. A national charities commission should be established to monitor, regulate and provide advice to all NFP organisations (including prescribed private funds). The commission should be tasked with streamlining the NFP tax concessions, and modernising and codifying the definition of a charity.

In addition to reducing complexity and compliance costs for NFP organisations, the commission would facilitate the collection of comprehensive data on the sector. The data collected could be used to target government support for the sector better, and would help individual donors make more informed choices about their giving.

### **Permit NFP organisations to undertake commercial activities**

NFP organisations should have scope to conduct commercial activities freely. This approach would reduce costs associated with education, assistance, advice, disputes and litigation on the ATO's interpretation of a 'charitable purpose',<sup>16</sup> and would reflect the principles of the High Court of Australia's Word Investments decision.

### **Reconfigure FBT concessions to improve competitive neutrality**

The FBT concessions should be removed and replaced with a more neutral form of assistance.

However, in recognition of their importance in helping NFP organisations to deliver their services, these concessions should be phased out over 10 years to provide recipient NFP organisations with sufficient time to adjust the prices they charge for their services, and to renegotiate employment contracts and funding models.

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15 Reviews include the 1995 Industry Commission study on charitable organisations in Australia; the 2001 Senate Committee inquiry into the definition of charities and related organisations; the 2008 Senate Committee inquiry into disclosure regimes for charities and NFP organisations; and the 2009 Productivity Commission study on the contribution of the NFP sector.

16 For example, the distinction between a related and unrelated commercial activity could be contentious — the Seventh Day Adventist Church has publicly argued that the tenet of vegetarianism advocated by their religion is advanced through the sale of vegetarian products by their Sanitarium business.

### Transitional adjustments

During the transition period, the value of the capped concessions would gradually be reduced. Reportable fringe benefits for affected employees (that is, those benefits that are readily valued and attributed) would be exempt up to the relevant cap, and taxed at the employee's marginal rate above the cap. The value of all reportable fringe benefits should be taken into account for transfer purposes (see Section A1).

As with other employers, non-reportable fringe benefits should be taxable for NFP employers at the top marginal tax rate.

### New arrangements

The benefits to NFP organisations of FBT concessions should be replaced with direct government funding. All NFP organisations eligible for tax concessions should be eligible to apply for funding for specific projects, or to assist with the costs of recruiting specialist staff. This would significantly simplify the number of classes of NFP organisation described in Table B3.1, and would facilitate the charities commission's task of codifying the definition of a charity. Where possible (particularly in relation to health), subsidies should shift to the relevant Australian government portfolio agency. For activities where there is no relevant agency, subsidies should shift to the charities commission.

The process for applying for funding, and the principles that would underpin decisions, should be subject to extensive consultation with the sector.

### Enhance the operation of the mutuality principle

Simple, efficient and concessional tax arrangements should be established for clubs with large trading activities in the fields of gaming, catering, entertainment and hospitality. One option is to apply a concessional rate of tax to total net income from these activities above a high threshold. For clubs below the threshold, no tax would be applied to income from these activities.

The threshold should be supported with appropriate integrity mechanisms to prevent affected clubs from splitting their operations into smaller clubs to circumvent the threshold.

This approach would be simple for clubs to understand and apply, and would assist in better targeting the application of the mutuality principle.

Appropriate transitional arrangements should be designed in consultation with the NFP sector.

