

TAXING CAPITAL INCOME: OPTIONS FOR REFORM IN AUSTRALIA

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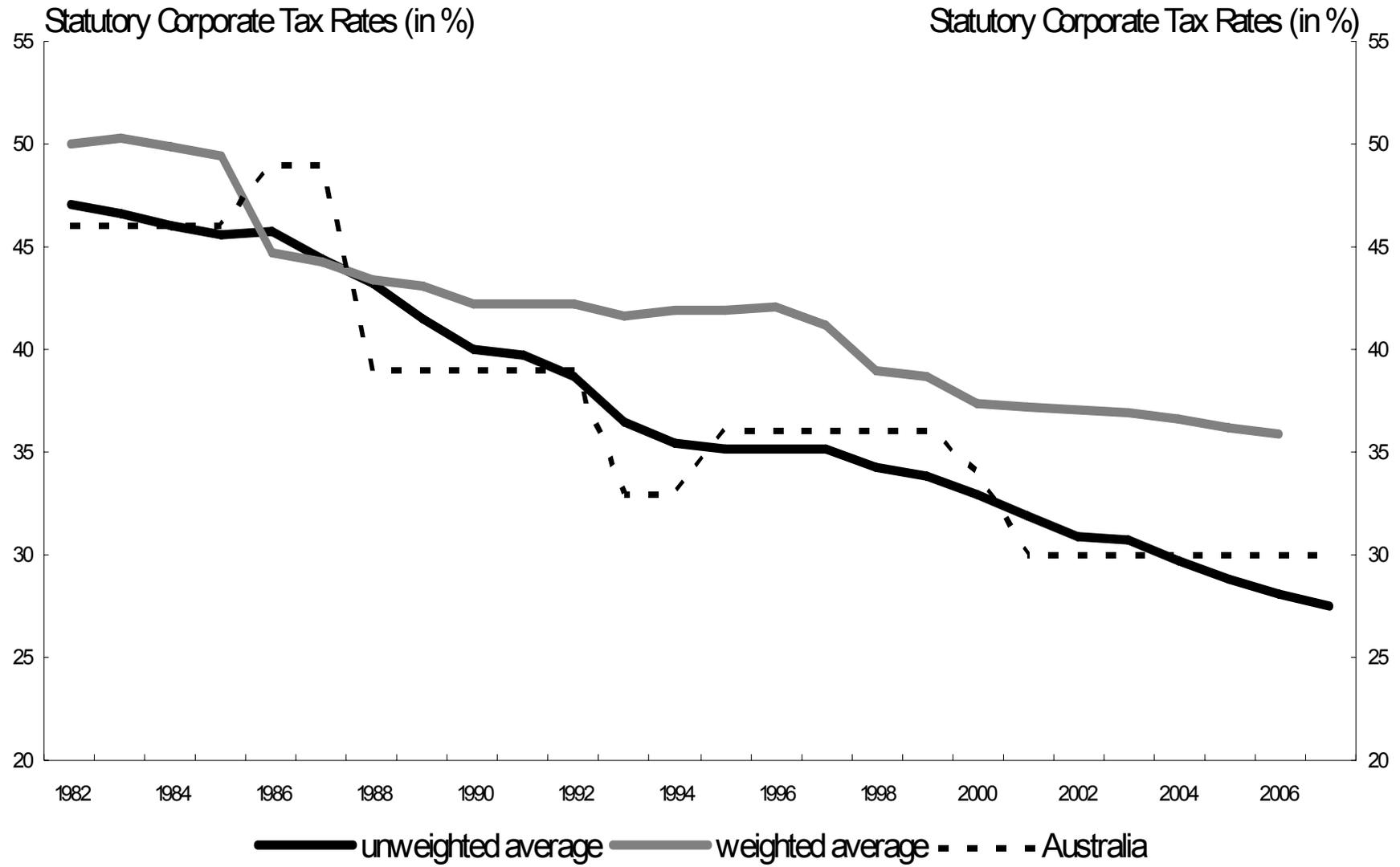
AGENDA

- The current Australian capital income tax system
- Effects of capital taxation in the open economy
- Goals of a capital income tax reform for Australia
- A detailed reform proposal

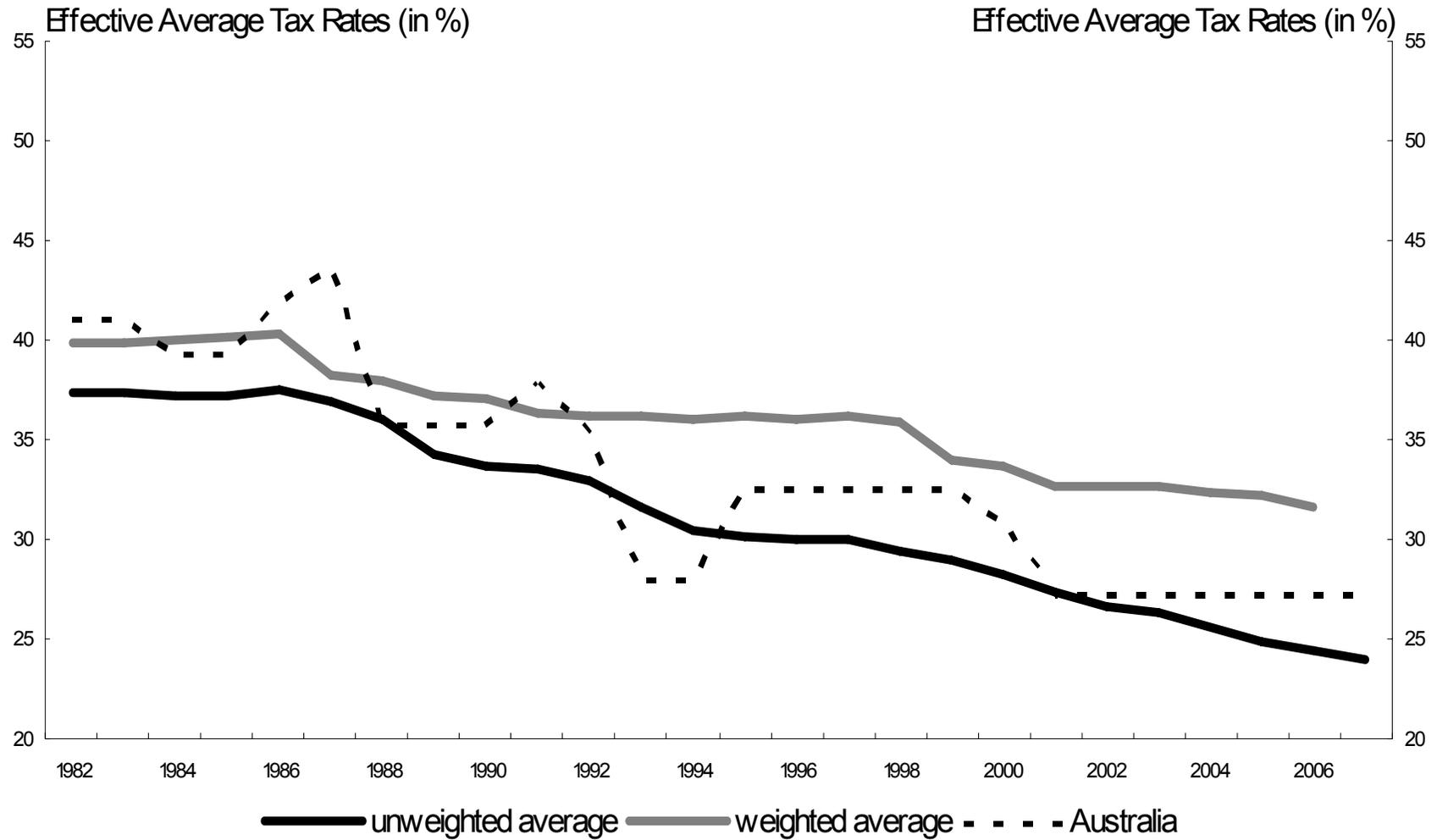
The Australian system of capital income taxation: company tax

- Statutory CIT rate = 30%
- Generous capital allowances for several asset classes
- Double taxation of dividends to domestic residents relieved through full imputation
- International double taxation relieved through dividend exemption system

Statutory corporate income tax rates in the OECD



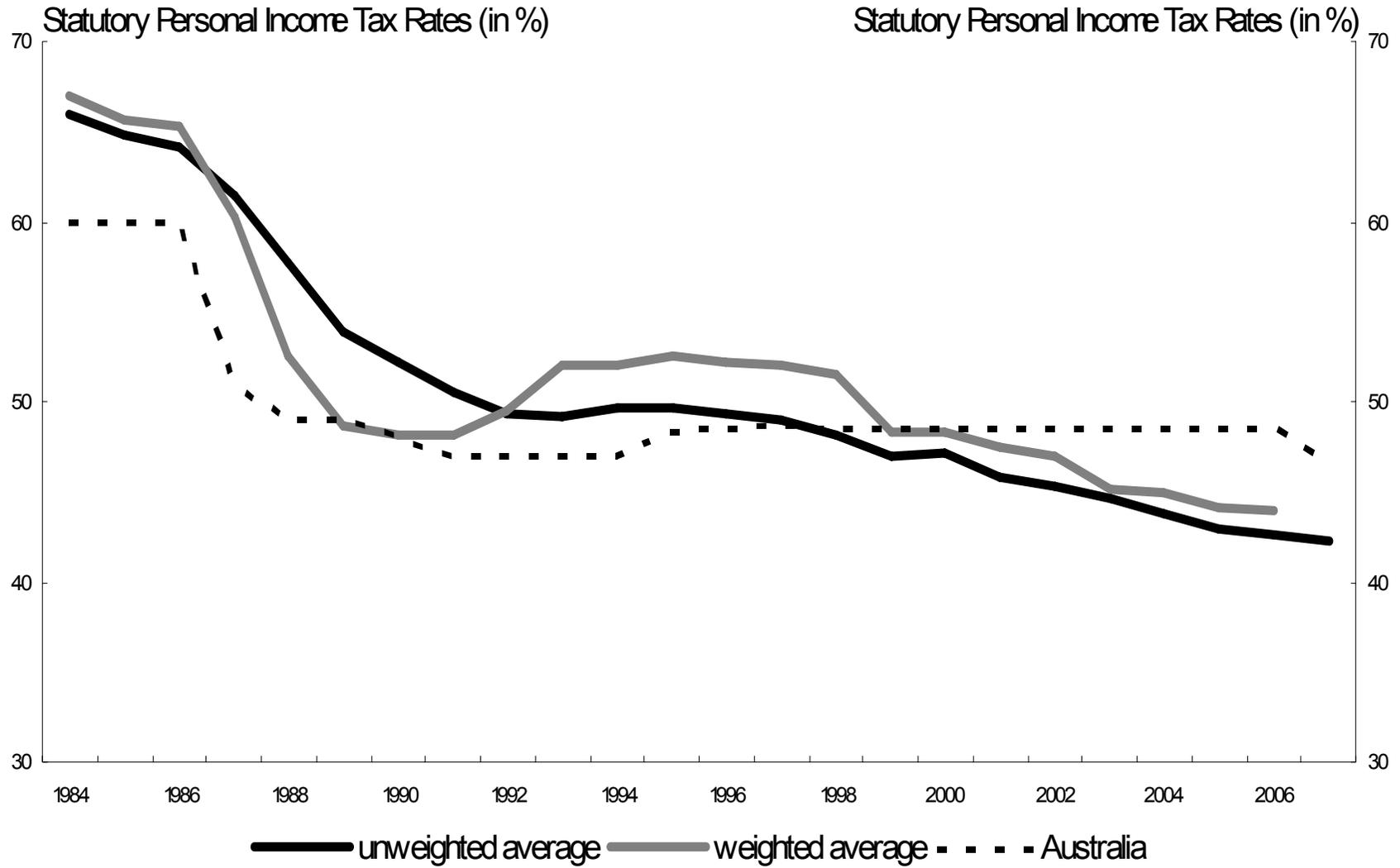
Effective average corporate tax rates in the OECD



The Australian system of capital income taxation: personal tax

- In principle, Australia adheres to worldwide comprehensive income taxation
- Top marginal tax rate on capital income = 46.5%
- Means testing of benefits may push effective marginal tax rates to much higher levels
- In general, only 50% of realised capital gains are subject to personal income tax
- No taxation of imputed rents and capital gains on owner-occupied housing → tax preference for home equity
- Tax preference for retirement saving through Superannuation funds

Top personal tax rates on capital income in the OECD



Taxes on investment versus taxes on saving

$$\begin{array}{c} \text{Total} \\ \text{tax wedge} \\ \hline p - s \end{array} = \begin{array}{c} \text{Investment tax wedge} \\ \text{(corporation tax)} \\ \hline (p - r) \end{array} + \begin{array}{c} \text{Savings tax wedge} \\ \text{(personal income tax)} \\ \hline (r - s) \end{array}$$

p = required pre-tax return on investment

s = after-tax return to resident saver

r = international cost of finance
(interest rate or required return on shares)

Note: r is given from the world capital market

Investment tax wedges in Australia

(in per cent of pre-tax return)

| Asset type | METR | | AETR | |
|-----------------|------|--------|------|--------|
| | Debt | Equity | Debt | Equity |
| Bonds | 0 | 38 | 19 | 34 |
| Land | -24 | 25 | 5 | 21 |
| Building | -21 | 30 | 13 | 30 |
| Truck | -38 | 25 | 10 | 28 |
| R&D | -93 | 18 | 1 | 25 |
| Acquired patent | -9 | 34 | 16 | 32 |

Assumptions: Inflation rate = 2.5%, real interest rate = 6%, economic rent = 10%.

Savings tax wedges in Australia

(Marginal Effective Tax Rates in per cent)

| | Top tax bracket | Bottom tax bracket |
|--|--------------------|-----------------------|
| Owner-occupied home | 0 | 0 |
| Rental property | 35 | 10 |
| Superannuation (salary sacrifice, franked dividend) | -108 | -21 |
| Bank/bonds | 66 | 21 |
| Listed shares (franked dividend) | 23 | -21 |
| Unincorporated business equipment | 63 | n.a. |

Assumptions: Inflation rate = 2.5%, real interest rate = 6%.

Key propositions on capital income taxation in a small open economy

- A source-based tax on the normal return is more than fully shifted onto domestic immobile factors and so reduces their welfare
- A source-based tax on immobile (location-specific) rents is non-distortionary
- A source-based tax on mobile (firm-specific) rents distorts location decisions
- Double tax relief for domestic shareholders does not reduce the cost of capital for companies with access to the international stock market, but may reduce the cost of capital for small domestic companies

A capital income tax reform for Australia

Main goals of reform

- Eliminate source taxes on the normal return
- Avoid increase in taxes on mobile rents
- Increase taxes on immobile rents
- Eliminate inter-asset investment distortions
- Move corporate double tax relief from the shareholder to the company level
- Aim at uniformity and neutrality under the personal capital income tax and avoid capital flight

Achieving the goals

Corporate income tax:

- Allowance for an imputed return on corporate equity (ACE)
- Improve possibilities for utilisation of tax losses

Personal income tax:

- A dual personal income tax (DIT) combining a low flat tax rate on capital income with progressive taxation of labour income

Calculating the base for ACE

Equity base in previous year

+ taxable profits in previous year (gross of the ACE)

+ exempt dividends received

+ net new equity issues

- tax payable on taxable profits in previous year

- dividends paid

- net new acquisitions of shares in other companies

- net new equity provided to foreign branches

= Equity base for the current year

Neutrality of the ACE

i = rate of interest = imputed rate of return

δ = rate of depreciation for tax purposes

Present value of total allowances triggered by one unit of investment:

$$\frac{i + \delta}{i + \delta} = 1: \text{ Equivalent to full expensing}$$

Note: the present value of allowances is independent of the rate of depreciation for tax purposes \rightarrow no distortion from accelerated depreciation. Any mismeasurement of profit is offset by a corresponding change in future ACE allowances

Setting the imputed rate of return under the ACE

- Full neutrality requires that the imputed return be equal to the shareholders' discount rate
- With full loss offsets, the tax saving from the ACE is a risk-free cash flow, so the imputed rate of return should then be the risk-free interest rate
- With imperfect loss offsets, rough neutrality could be achieved by setting the imputed return equal to the average corporate bond rate
- Neutrality could be improved by allowing companies to offset tax losses against other taxes (e.g. GST, pay-as-you-go income tax)

The choice of tax rate and the transition to an ACE

- To avoid exacerbating the transfer-pricing problem, the statutory corporate tax rate should not be raised. The owners of domestic factors will benefit from the ACE even if they have to make up for the revenue loss
- To limit the revenue loss the initial equity base should be set at zero. This will require anti-avoidance rules to prevent tax-motivated liquidations and new start-ups

Estimated revenue effects of an ACE in Australia

- Long run revenue loss if the ACE is granted also for "old" equity and all allowances are fully utilised (full loss offset, imputed return = 5%): 1.9 per cent of GDP
- Present value of revenue loss if the ACE is only granted for new equity: 0.95 per cent of GDP
- Revenue gain from abolition of franked dividend tax credits: 1.2-1.5% of GDP

The dual personal income tax: The case for a low flat tax rate on capital income

Arguments for a *low* capital income tax rate:

- accounts for inflation in a pragmatic way
- reduces incentive for capital flight
- improves neutrality, allows base broadening

Arguments for a *flat* capital income tax:

- Reduces lock-in effects of realisations-based capital gains tax
- Limits the scope for tax arbitrage
- Reduces clientele effects
- Allows tax collection through final withholding at source

The personal capital income tax base under the Dual Income Tax

Interest

- + dividends (imputation system abolished)
- + capital gains (full nominal gain included)
- + rental income
- + royalties from acquired intangible assets
- + imputed returns on capital invested in non-corporate firms
- + imputed returns on owner-occupied housing

= capital income

Taxing income from self-employment under the DIT

- **Problem:** the self-employed earn income from capital as well as labour
- **Solution:** tax an imputed return to business assets as capital income and treat the residual business income as labour income

Defining business assets

- Depreciable business assets plus acquired goodwill and acquired intangible assets
- Business assets must be separated from "private" assets

Note: Income splitting should be an option but not an obligation. If a proprietor does not opt for income splitting, all of his/her income will be taxed as labour income

Taxing income from closely held companies under the DIT

- **The income shifting problem:** Active owners of small companies may transform labour income into capital income to reduce their tax bill if the sum of the corporation tax and the personal tax on dividends is lower than the (top) marginal tax rate on labour income

Solving the income shifting problem

Set tax rates so as to roughly satisfy

$$\tau + t(1 - \tau) = m$$

τ = corporate income tax rate

t = personal capital income tax rate

m = top marginal personal labour income tax rate

The capital gains tax problem

- **Problem:** Lock-in effect of realisations-based taxation because of gain from deferral. In particular, owners of closely held companies could gain from accumulating income within the company
- **Solution for *listed* shares:** Accruals-based taxation

Solving the capital gains tax problem for unlisted shares in domestic companies

- Step up the basis of shares each year by the company's retained profit and impose capital income tax on the increase in basis value
- If a share is sold at a price exceeding the stepped-up basis value, the additional gain is taxed as capital income
- If a share is sold at a price below the stepped-up basis value, the loss is deductible against other capital income (or entitles the taxpayer to a tax credit against the tax on labour income)

Advantages of capital gains tax regime for unlisted shares

- No valuation problem: capital gains tax liability is based on the company's taxable retained profits
- No liquidity problem: tax is only liable in so far as the company earns positive taxable profits. The company can pay the flat tax on behalf of shareholders
- Taxation of additional realised gains ensures taxation of gains stemming from higher expected future earnings and loss offset protects against overtaxation

Taxing returns to property

- Risk-Free Return Method (RFRM): Set taxable income equal to an imputed risk-free rate of return on the assessed value of the property
(ex ante neutrality, implies taxation of the value of housing services plus expected rather than actual capital gains → no lock-in effects)

Apply the RFRM to

- owner-occupied housing
- rental property

To improve neutrality:

- eliminate stamp duties

Note: the RFRM can also be applied to shares in foreign unlisted corporations

Superannuation

- No rationale for tax concessions to retirement saving
- Tax superannuation under the same rules as ordinary saving to improve neutrality (but allow government co-contributions for low-income earners)

Enforcing the residence principle

- **Problem:** Foreign tax authorities have no incentive to provide information to domestic tax collectors
- **Solution:** Offer foreign governments a share in the revenue gain when foreign authorities provide information allowing enforcement of domestic tax on foreign source income

Revenue effects of switch to a DIT

- Potential capital income tax base (excluding personal use assets) assuming a 5% nominal rate of return: 20% of GDP
- Revenue at a 20% capital income tax rate: 4% of GDP
- Current personal capital income tax revenue: 1.5-2% of GDP →
- Expected revenue gain from DIT: 2-2.5% of GDP (excluding gain from ordinary taxation of Superannuation contributions)
- Memo: Expected revenue loss from the ACE: 0.9% of GDP

Taxation of natural resources

- Replace the current taxes and royalties with a graduated uniform rent tax on the same base as the ACE company tax (i.e. surtaxes on rents above certain threshold levels)

Advantages:

- Neutrality
- Potential for increased revenue
- Administrative gain from integration with ACE system

Effects of reform on investment tax wedges (in per cent of pre-tax return)

| Asset type | Current METR | | METR after reform | |
|-----------------|--------------|--------|-------------------|--------|
| | Debt | Equity | Debt | Equity |
| Bonds | 0 | 38 | 0 | 0 |
| Land | -24 | 25 | 0 | 0 |
| Building | -21 | 30 | 0 | 0 |
| Truck | -38 | 25 | 0 | 0 |
| R&D | -93 | 18 | 0 | 0 |
| Acquired patent | -9 | 34 | 0 | 0 |

Assumptions: Inflation rate = 2.5%, real interest rate = 6%.

Effects of reform on investment tax wedges (in per cent of pre-tax return)

| Asset type | Current AETR | | AETR after reform | |
|-----------------|--------------|--------|-------------------|--------|
| | Debt | Equity | Debt | Equity |
| Bonds | 19 | 34 | 19 | 19 |
| Land | 5 | 21 | 19 | 19 |
| Building | 13 | 30 | 19 | 19 |
| Truck | 10 | 28 | 19 | 19 |
| R&D | 1 | 25 | 19 | 19 |
| Acquired patent | 16 | 32 | 19 | 19 |

Assumptions: Inflation rate = 2.5%, real interest rate = 6%, rent = 10%.

Effects of reform on savings tax wedges (Marginal Effective Tax Rates in per cent)

| | Current system (top tax bracket) | After reform |
|---|-------------------------------------|-----------------|
| Owner-occupied home | 0 | 28 |
| Rental property | 35 | 28 |
| Superannuation (salary sacrifice, franked dividend) | -108 | 28 |
| Bank/bonds | 66 | 28 |
| Listed shares (franked dividend) | 23 | 28 |
| Unincorporated business equipment | 63 | 28 |

Assumptions: Inflation rate = 2.5%, real interest rate = 6%.

Efficiency gains from the proposed capital income tax reform

- Reduced tax distortion to inbound investment

Improved tax neutrality between

- debt and equity
- distributed versus retained earnings
- proprietors and owners of closely held companies
- investment in financial assets and investment in owner-occupied housing

Additional background slides

Allocation of Australian household assets

- Own home: 44 %
- Other property: 16%
- Superannuation funds: 13%
- Shares and interests in trusts: 12%
- Personal use assets: 11%
- Bank accounts and bonds: 4%

Corporate tax revenues in the OECD (% of GDP)



Taxing imputed returns on owner-occupied housing through the Risk-Free Return Method

Capital market equilibrium in the absence of tax:

$$i = \overbrace{h - \delta + g - p}^{\text{expected risk-adjusted nominal return to housing investment}} \quad (1)$$

Capital market equilibrium with tax on imputed rent:

$$i(1-t) = h - \delta + g - p - t\rho \quad (2)$$

For $\rho = i$ (neutral taxation) it follows from (1) and (2) that

$$t \cdot \rho = t \cdot (h - \delta + g - p) \quad (3)$$

Hence neutral taxation according to the *RFRM* method involves taxation of the expected capital gain g rather than the actual gain