

## Submission to Review of Australia's Tax System

(With specific reference to questions Q6.3 and Q6.6 of the  
Consultation Paper)

### Company Taxation and Debt

— In his book, *Corporate Collapse; The Causes and Symptoms* (McGraw-Hill, 1976), Ch. 7, Argenti says: "High gearing and an economic downturn are the classic nutcrackers of failure". Thirty-three years on and we still have not learnt that lesson. The viability of many companies is currently threatened by excessive exposure to debt, as it was in previous recessions, so company failures can be expected over the next few years.

But the reasons for over-borrowing are more than just reckless financial management. They are ingrained in a taxation system that actually encourages borrowing. Tax deductibility of interest on borrowings creates a price distortion that favours borrowing over equity.

That distortion needs to be removed. One way is to remove the deductibility completely. This could be done as a **trade off against a lower company tax rate**. Another way is by indexation of interest payments, so that the lower **real** amount would be used for tax purposes, both for borrowers and lenders. (For lenders it would remove the inequity of taxing the inappropriate nominal amount.)

The above proposals may meet opposition from investors who believe that company profits may be reduced (depending on the company tax rate outcome). But as a risk averse self-funded retiree who depends substantially on dividends for income, let me say I would prefer a tax regime that induces stability into the economy and into company profits than one that doesn't.

My comments above are directed mainly at company borrowings. Although the problem of price distortion also applies to small unincorporated businesses, retention of tax deductibility status for them could be justified by the fact that they do not have the same access to equity raising as do public companies, and also because they do not have a large number of public shareholders who need protection from reckless management decisions.

The issues are of course much more complex than I have outlined above, but I believe are worthy of further research.

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