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A KPMG submission to the Australia's Future Tax System Review

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Foreword

We welcome the opportunity to comment on the AFTS consultation paper of December 2008.

Our first submission examined the potential impacts on Australia's reliance on the taxation of capital income and looked beyond the borders to examine the various corporate tax regimes around the world. The submission also looked at the level of complexity Australian businesses face within our own national borders, particularly, in relation to state-federal interactions and the impact this has on certainty and compliance.

In this submission, we continue the analysis on corporate tax systems, by focusing on the practical consequences of pursuing a particular corporate tax system in an Australian context, such as ACE or a cash flow tax system. We also explore how corporate-shareholder integration systems have been implemented in other countries. It is our objective that this submission can contribute to the extensive academic debate in this area, by offering a tax practitioner's perspective on the implementation of these systems.

We look forward to seeing further outcomes and recommendations from the AFTS review, and would be pleased to further discuss any of the areas covered in this submission.

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Table of terms

A table of terms used in this submission is provided below.

ABN	Australian Business Number
ABS	Australian Bureau of Statistics
ACE	allowance for corporate equity
ACCI	Australian Chamber of Commerce and Industry
ACT	Australian Capital Territory
AFTS Review	Australia's Future Tax System Review
ANTS	Tax Reform: not a new tax, a new tax system
ALP	Australian Labor Party
APEC	Asia-Pacific Economic Cooperation
Architecture Paper	Australian Treasury discussion paper *Architecture of Australia's tax and transfer system*
ASE	allowance for shareholder equity
ASIC	Australian Securities and Investment Commission
ASPAC	Asia Pacific
Asprey Report	Commonwealth Taxation Review Committee, Full Report 31 January 1975
ATO	Australian Taxation Office
BAS	business activity statement
BIE	Bureau of Industry Economics
BoT	Board of Taxation
CBIT	comprehensive business income tax
CCFT	corporate cash-flow taxation
CGT	capital gains tax
CEDA	Committee for the Economic Development of Australia
CESIfo	Center for Economic Studies (CES), the Information and Forschung (IFo) Institute for Economic Research
CIS	The Centre for Independent Studies
COAG	Council of Australian Governments
CPRS	Carbon Pollution Reduction Scheme
DTA	double tax agreement
EC	European Commission
ECJ	European Court of Justice

EFT	entity flow-through
EMTRs	effective marginal tax rates
EPRU	Economic Policy Research Unit
ETS	Emissions Trading Scheme
EU	European Union
FAQ	frequently asked question
FDI	foreign direct investment
FBT	fringe benefits tax
GAA	Global Accounting Alliance
GDP	gross domestic product
Government	Australian Commonwealth Government
GST	goods and services tax
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IFS	the Institute for Fiscal Studies
IPART NSW	Independent Pricing and Regulatory Tribunal of New South Wales
IMF	International Monetary Fund
ICAA	The Institute of Chartered Accountants in Australia
the Institute	The Institute of Chartered Accountants in Australia
ITAA	Income Tax Assessment Act
NSW	New South Wales
NT	Northern Territory
NZ	New Zealand
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of the Petroleum Exporting Countries
PAYG	pay as you go
PRRT	petroleum resource rent tax
Qld	Queensland
R&D	research and development
RATS	Reform of the Australian Tax System
RATS Draft Whitepaper	Australian Treasury whitepaper *Reform of the Australian Tax System: Draft White Paper'*
RBT	Review of Business Taxation
Review Panel	Australia's Future Tax System Review Panel
RIM	retirement and income modelling
RRA	rate of return allowance

SA	South Australia
shareholder ACE	shareholder allowance for corporate equity
SMEs	small to medium enterprises
Tas	Tasmania
TIES	tax issues entry scheme
TOFA	taxation of financial arrangements
TVM	tax value method
UK	United Kingdom
US	United States
USSR	Union of Soviet Socialist Republics
VAT	value added tax
Vic	Victoria
WA	Western Australia

1 Executive Summary

As tax professionals, we often try to approach business tax reform in very practical terms. Engaging in academic debate attracts considerable interest and is useful in deciphering options of either radically reforming or simply finetuning a tax system. But, it is the practical consequences of a new system that assists us in understanding the true extent of the costs or benefits of implementing a tax system for business.

In October 2008, KPMG together with the ICAA lodged a submission, *Thinking beyond borders – tax reform for the 21st century* (first submission), for the AFTS Review, which focused on how Australia could potentially improve productivity and drive growth through reform to the taxation of business. In particular, this submission focused on the corporate-shareholder integration tax regimes around the world and the pros and cons of each in comparison to the current Australian system. The submission also examined the impacts of Australia's reliance on the taxation of capital income.

In designing a tax system for business that seeks to address the challenges confronting business, considerations of the reliance on capital taxation needs to be factored in with related considerations of the appropriate tax base, the tax that should apply on the distribution of profits, and the appropriate design of the personal tax system.

On the corporate tax rate, we find the burden of taxation in more recent years been increasing on the corporate tax sector. This is becoming increasingly uncompetitive and consideration should be given to placing less reliance on capital taxation.

On the tax base, an expenditure tax base such as ACE or a cash flow tax system are options that Australia could consider. Achieving neutrality between debt and equity are clearly one of the benefits of adopting an ACE system, removing the need for complex debt/equity and thin capitalisation rules. However, introducing an ACE system should not compromise a reduction in capital taxation. Instead, consideration should be given to recalibrating the current mix of taxation. Under a cash flow tax system, the potential high transitional costs of moving to a cash flow tax system needs to be weighed against its potential benefits.

On the taxation of the distribution of profits, a strong case for removing Australia's current imputation system has yet to be formulated. However, Singapore's one tier dividend exemption system is attractive predominantly because of its simplicity.

As a global network of professionals, we have occasion to offer advice in regard to other countries' income tax systems and therefore, had to consider income taxation in practical terms. By viewing the corporate tax systems from this perspective, we hope to open for discussion propositions that may support (or perhaps even reject) the substantial academic research that has been (or will be) devoted to formulating a new policy framework for Australia's tax-transfer system. In this submission, we focus on business taxation and in particular, the advantages or disadvantages that other countries have experienced in implementing a particular corporate tax system. In particular, through preliminary discussions with our international offices, we consider the ACE in Belgium; the cash flow tax system in Estonia; the one tier dividend exemption system in Singapore; and the ASE system in Norway, from a practical perspective.

2 Creating an attractive business environment in Australia

Australia's tax system needs to evolve to respond to globalisation and the need for greater economic integration. This is particularly important for Australia given its geographical location and its "effective remoteness" in comparison to its major economic partners such as the US and the EU.

Research has found that countries economically smaller and farther away from international markets are likely to be poorer than those that have larger domestic markets and that are closer. Based on empirical evidence, a 10 percent increase in distance reduces trade by around 10 percent and that this effect has not diminished over the last 30 years.[1] In a recent OECD economic survey report on NZ, sources of NZ's prosperity gap was attributed to NZ's remoteness to its major trading partners. Given Australia is within a similar proximity to NZ in a geographical sense, the conclusions on the linkage between distance and the effect on international trade may equally apply to Australia.

However, as China, India and other Asian countries continue to be integrated into the global economy, the centre of economic gravity will shift away from Europe and the US towards Asia. In theory, the position of Australia will be improved, relative to key markets, thereby lessening the negative impact of economic geography.

Irrespective of this shift in economic gravity, Australia will benefit from domestic tax policy settings that lower the cost of moving capital, people, goods, services and ideas would hopefully make it attractive to innovate, locate in or do business with Australia.

In the context of business taxation, our first submission emphasised the high relative reliance on the taxation of capital income in Australia, which results from the relatively high contributions from company tax. The revenue collected from property (e.g. taxes on immovable property and stamp duties on capital transactions) and the taxation of personal capital income (e.g. personal taxes on the disposal of shares and the receipt of rents, interest and dividends) also contribute to the high relative weight given to Australia's taxation of capital income. The heavy reliance on capital taxation becomes a pressure point on incentives to save, resource allocation and risk taking.

To address this issue, a solution that simply reduces the statutory corporate tax rate cannot be considered without consideration of interconnected issues such as determining the appropriate tax base and the appropriate tax rate on the distribution of profits.[2] These issues are discussed in the next section of this submission. There are also connected considerations in relation to the appropriate design of the personal tax system. As our submission focuses on business taxation, we do not propose to discuss the appropriate design of the personal tax system in this submission.

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[1] OECD, *OECD Economic Surveys: New Zealand,* Chapter 2 pp 58, 59 (2009)
[2] Smith, G, *Australian Tax Reforms: Past and Future*, (2009)

3 Policy considerations

A proposition that seems to be generally accepted is that economic growth is associated with lower levels of capital taxation in the overall revenue mix.[3]

From a business taxation perspective, we recognise that simply reducing the statutory corporate tax rate cannot be considered in isolation. Interconnected issues that will need to be considered in designing a tax system include:

- What is the appropriate statutory rate?
- What is the appropriate tax base?
- What tax should apply to distribution of profits?

We discuss some of the propositions set out in our first submission on the AFTS Review and further thinking that has been developed since then.

3.1 What is the appropriate statutory rate?

Australia should have an aspirational goal to reduce the corporate tax rate to 20 percent. This should ensure the reduction is worthwhile from the viewpoint of the Australian economy reaping the benefits of greater economic growth and productivity in the long run from such a change.

We arrived at this conclusion by considering two key factors:

- As at 1 April 2008, the annual KPMG survey of global corporate tax rates illustrates of the 106 countries surveyed, the global average (including countries across the OECD, EU, ASPAC and Latin America) was 25.9 percent. Thus, even if Australia's corporate tax rate was cut to 25 percent, it would at best align Australia's corporate tax rate to the global average.
- Economic studies to date have supported the proposition that a reduction in the corporate tax rate leads to second order benefits measured in terms of higher levels of economic growth and foreign investment that could potentially outweigh the short-term revenue costs.

Taxes on income and profits (the corporate and personal income taxes) are considered to distort economic activity to a greater degree than consumption-based taxes and in particular, the corporate income tax is particularly harmful to growth.[4]

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[3] KPMG and ICAA, *Thinking beyond borders – tax reform for the 21st century, A joint submission by KPMG and the Institute of Chartered Accountants in Australia to the Australia's Future Tax System Review,* Chapter 5 (October 2008)
[4] OECD, *OECD Economic Surveys New Zealand,* Chapter 2 p 69 (2009)

Whilst we recognise that current fiscal conditions may not permit an immediate reduction in the corporate tax rate, one option that should not be ruled out is the option to recalibrate the taxation mix such that less reliance is placed on corporate tax and more reliance is placed on GST. This option was also supported in the recent OECD economic survey on Australia.

We understand that setting an appropriate statutory rate will be dependent on how tax base will be formulated under the AFTS Review. For example, one approach would involve retaining a broad income tax base and lowering the company tax rate. Another approach, would involve narrowing the company tax base in preference to reducing the existing company tax rate.

The company tax rate is the most visible feature of the business tax system of a country. While there has been much literature that argues it would be misleading to use this rate as the overall yardstick for a business tax system, it is a feature that attracts considerable attention as many investors may regard the tax rate as an indicator of other aspects of the business tax system.

Australia's statutory corporate tax rate has remained unchanged since 2001, whilst the rest of the world has progressively reduced corporate tax rates. Countries in ASPAC, such as Singapore and Hong Kong with corporate tax rates of 18 percent and 16.5 percent respectively, are not readily comparable to Australia in many respects, but nevertheless are located in the same geographical region as Australia and established businesses are competing for the same regional investment dollar. The global trend in corporate tax rates over the past seven years has been downwards and Australia should also consider a similar path.

3.2 What is the appropriate tax base?

The AFTS Review is interested in the relative merits of income and expenditure (or cash-flow) tax bases. The consultation paper mentions two types of business level expenditure taxes. Expenditure taxes can be either provide an allowance for the return on equity (ACE) or based on cash flows. However, the consultation paper notes that whilst these systems have attracted considerable interest among tax policy specialists, the practical consequences are not fully understood.[5]

Our first submission explored the relative pros and cons of an ACE system and a business cash flow system. Since then, we have further explored how these two systems have applied in practice through preliminary discussions with our senior tax contacts in KPMG offices in Belgium and Estonia, who have extensive expertise in the implementation of these respective systems in their countries. We highlight below the practical ramifications of implementing these systems in these countries. At a high level, the main issues we have sought to address in relation to each corporate tax system include the following:

- The success of the particular corporate tax system in achieving policy goals of eliminating fiscal discrimination between debt and equity and in fostering small and business enterprises.
- The positive or negative impact on the revenue collected from corporate taxation.
- The impact (if any) on the returns to shareholders.
- The impact on foreign direct investment (if any).

3.2.1 ACE in Belgium

The ACE operates by allowing a deduction equal to the imputed ('normal') return to equity. In theory, the ACE can provide a more neutral treatment between debt and equity. If an ACE system is adopted, there is also the advantage of working within the existing Australian income tax framework and thus, making implementation easier. Belgium has an ACE system, known as the 'notional interest deduction' system. [6]

[5] Australian Treasury, Australia's future tax system, Consultation paper, Chapter 6 p 136 (December 2008)
[6] Belgium's tax regime that recognises a deduction for equity is not usually known as ACE but instead a 'notional interest deduction' regime.

Background

From 1 January 2006, Belgium replaced its 'coordination centre' regime with a 'notional interest deduction' regime. Introducing a 'notional interest deduction' for equity was in part to attract new equity-funded entities; to reduce the fiscal discrimination between debt and equity; and to maintain and further develop small and medium-sized companies.

The coordination regime was phased out as a result of pressure from the EC, which examined taxation regimes that were disturbing the economic environment of the EU. The EC saw Belgium's coordination centre regime as attracting more capital to Belgium than other EU members and thus, this regime was considered by the EC as 'discriminatory' in the EU.

Belgian domestic policies also greatly influenced the introduction of a notional interest deduction regime. At the time, an overt cut in the corporate tax rate was opposed, which led to a search for a corporate tax system that was internationally competitive for all companies.

Under Belgium's notional interest deduction regime, a company is treated as if it had borrowed its own funds (equity) at an annual rate equal to that of ten-year government bonds. This 'notional interest' (or the 'risk capital deduction) is deducted from the tax base.

The success of the ACE in achieving policy goals of eliminating fiscal discrimination between debt and equity and in fostering small and business enterprises

The first to use this system were multinational companies, insurance companies and banks as they were excluded from the coordination centre regime prior to 2006.

However, in practice, the notional interest deduction regime took a lot longer to become popular and effective for SMEs. SMEs can obtain a higher rate of the notional interest deduction, with an additional 0.5 percent above the normal rate for other taxpayers.

Since introducing a notional interest deduction regime, many companies in Belgium have considerably reduced their debt levels, whilst equity levels have increased. This trend has particularly been prevalent with SMEs. There is less incentive to borrow and more incentive to retain funds internally.

The ACE system eliminates the discrimination between debt and equity financing, removing most of the thin capitalisation issues. There is a perception that the greater reliance on equity funding rather than debt funding means that Belgian businesses may be anecdotally more robust than those many other countries during global financial crisis. However, this is difficult to prove in isolation given Belgium's close economic integration with other EU countries.

One of the current practical issues is that interest rates are falling, but the notional interest deduction is still very high because it is based on the rate of the prior year, 10 year bond rate. If the year-on-year variation is too large (that is, there is more than one per cent variation), it can be modified by the Belgian Government.

Furthermore, larger companies have practical issues in calculating the notional interest deduction, as equity has to be corrected/adjusted for levels of equity participation. This is less problematic for SMEs as there are less equity adjustments to make.

Another practical issue that has arisen is that the notional interest deduction has been set based on borrowings in Euros, providing an incentive for companies to finance in Euros. If instead, a company decides to finance in US dollars or Australian dollars, the notional interest deduction may not be sufficient because these currencies may have higher interest rates. This has resulted in certain Belgian companies in becoming more proactive in their hedging strategies.

The positive or negative impact on the revenue collected from corporate taxation

The impact has been important for Belgium's revenue collected from corporate taxation.

From discussions with our international offices, initial estimates suggest the net impact of introducing an ACE system had a negative impact on revenue.

Belgium's statutory corporate rate of tax is highest in Europe. The corporate income tax rate in Belgium is 33.99 percent. However, the introduction of a notional interest deduction regime has cut the effective tax rate substantially.

The impact (if any) on the returns to shareholders

Dividends are taxed in Belgium and are part of a taxpayer's corporate income tax liability. There does not seem to be a great impact on dividends distributed by companies.

As stated above, the corporate income tax rate in Belgium is 33.99 percent. When a shareholder receives a dividend there is withholding tax on this dividend. The withholding tax rate is normally 25 percent, however there may be some circumstances where it is 15 percent. This is the final tax on the dividend.

However, one difference is that SMEs now have higher amounts of equity.

The impact on foreign direct investment (if any)

The introduction of a notional interest deduction regime has demonstrated that the regime has been attractive for global foreign direct investment, as Belgium has attracted an increased capital inflow in recent years. However, this capital is mainly used for financing and is used to finance companies throughout the EU and the world.

The notional interest deduction regime was also seen to be important to attract company headquarters, service centres and distribution centres.

Belgium's main competition for financial services is the Republic of Ireland (with its low corporate income tax rate), Luxembourg and Switzerland.

We also understand that in terms of international investment coming into a country, since the introduction of notional interest deduction regime, Belgium has become more internationally competitive.

3.2.2 Cash flow tax and flat tax system in Estonia

Our first submission explored the advantages and disadvantages of a cash flow tax and a flat tax system in more detail.

The consultation paper describes the business cash-flow tax model as a system that provides a deduction in full for new investment at the time of acquisition. Income and expenses are recorded at the time cash comes in or goes out, making income and expenses recognition and depreciation rules unnecessary. Better neutrality between the treatment of debt and equity may also be achieved.[7] The paucity of examples where the cash flow tax system has been fully implemented suggests that the disadvantages may outweigh its advantages.

As discussed in our first submission, a flat tax is based on the principle that all income should be taxed at a single rate.

Background

In 2000, the corporate income tax (CIT) system was reformed so that corporations are exempted from the income tax on undistributed profits ie Estonia's cash flow tax system operates such that corporate tax is only levied on distributed profits. Corporate tax is payable by the business when profits are distributed currently at 21 percent.

In addition to a cash flow tax system, Estonia also has a flat tax system, where personal and capital income is taxed at the same single rate. Currently, the flat tax rate is 21 percent. Consumption tax is taxed with few exemptions at a rate of 18 percent (VAT), with some exceptions.[8] We also highlight briefly the practical consequences that have arisen from Estonia's flat tax system.

Impact of the tax system on economic growth and tax revenue

The zero corporate income tax on undistributed profits introduced in Estonia is unique and no OECD country has a similar feature. The main argument for introducing the system was the expected positive effect on investment and reinvesting profits. A 2009 OECD economic survey on Estonia observed that following the reform, reinvested profits and total investment have been steadily increasing from 2000 to mid 2007. However, as this period has been characterised by strong economic growth, it is difficult to distinguish between the effects of the tax reform and other factors.[9] Notwithstanding this, there is a perception that Estonia has been more successful economically than the adjacent Baltic States of Latvia and Lithuania, which have some geographic advantages.

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[7] Australian Treasury, Australia's future tax system, Consultation paper, Chapter 6 p 136 (December 2008)
[8] OECD, *OECD Economic Surveys Estonia,* Chapter 5 p 134-135 (2009)
[9] OECD, *OECD Economic Surveys Estonia,* Chapter 5 p 135 (2009)

In Estonia, productivity and investment benefits may be supported not only by the introduction of a corporate cash-flow tax system, but also other integrated features of Estonia's tax system.

The Estonia tax system is described as "simple and transparent, reducing compliance costs and incentives for tax evasion". In addition, in accordance with the World Bank Doing Business (2008) indicator on paying taxes, in 2007 Estonia was clearly below the OECD in several areas:

- Number of tax payments
- The time it takes to prepare, file and pay the corporate income tax, the value added tax and social security contributions.

Also, as mentioned above, Estonia has a flat tax system where personal and capital income are taxed at the same single rate, enhancing simplicity, transparency and ease of compliance of the tax system. The flat tax system also eliminates the need to adjust marginal rates for 'bracket creep. The reform reduced the negative impact of uncertainty on investment and established neutrality between different economic activities. Following Estonia's example, the flat tax became popular in central and east European countries eager to create a business climate that promotes entrepreneurship.

As a result of a very simple and transparent tax system individuals spend on average 10-15 minutes on submitting their annual tax return. In principle, taxpayers can access through Internet their tax return, which is already pre-populated by the revenue authority and they just need to confirm (or correct, if necessary) the data included in the tax return. In 2007, approximately 92 percent of taxpayers submitted their tax return through the Internet.[10]

The Estonian tax system relies on a mix of relatively low personal and corporate incomes taxes as well as a property and a broad-based consumption tax. This is in line with findings that indirect taxes are less distortionary than direct taxes (Johansson et al., 2008). However, the tax burden on labour is higher than on average in OECD countries due to high employers' social security contribution. This has resulted in less incentive for employers to hire workers and in cases where the burden of social security contributions are passed on to employees as lower wages, workers have less disincentives to supply labour.[11]

Impact of the tax system on profit retention

Although the Estonian corporate cash flow tax system is attractive in its simplicity and efficiency, some of its aspects may hamper growth by distorting incentives and hindering restructuring.[12] For example, the system discourages distributing dividends to shareholders and thus, arguably impedes capital mobility and investment in potentially more productive projects in other firms and industries.[13]

However, the incentive for companies to retain profits is considered to be a positive attribute during the global financial crisis, given the scarcity of debt financing.

Estonia's corporate cash flow tax system has also created some issues with non-EU DTA countries.

3.2.3 Considerations in an Australian context

The introduction of an ACE system in Belgium was influenced by domestic policies whereby a reduction in the corporate tax rate was opposed. It is interesting to speculate whether Belgium would have introduced such a system if a reduction in the corporate tax rate was contemplated as a possibility.

Nevertheless, should Australia consider implementing an ACE system for corporate taxpayers, there are questions as to how an ACE system would be funded. For example, will the current 30 percent corporate tax rate remain unchanged and greater reliance placed on indirect taxes?

Moreover, consideration needs to be given to setting an appropriate rate for the notional interest deduction. As Australian businesses become more globalised and exposed to greater funding in foreign currency, setting a notional

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[10] Ministry of Finance of the Republic of Estonia, *Questions and Answers: Estonian Flat Income Tax System* (January 2009)
[11] OECD, *OECD Economic Surveys Estonia,* Chapter 5 p 135 (2009)
[12] OECD, *OECD Economic Surveys Estonia,* Chapter 5 p 135 (2009)
[13] "Lock-in" effects of capital in existing businesses was identified as a deterrent to restructuring between industries, impeding the reallocation of resources within and across industries essential for the short-run recovery and sustainable longer-term growth. Whilst, the zero tax on retained earnings strengthened liquidity of the Estonian companies, it also contributed to potentially inefficient allocation of funds. OECD, *OECD Economic Surveys Estonia,* Chapter 5 p 136 (2009)

deduction rate that is a 'one size fits all' will be difficult to achieve and will require constant monitoring by the revenue authorities. As noted in the Belgium experience, this has proved to be a challenge and has required Belgium companies to become more proactive in their hedging strategies.

If Australia considers adopting a cash flow tax system, this would require a fundamental shift in the taxation of business and implementation costs would be high. Whilst there are clearly benefits of a cash flow tax system as experienced in Estonia, it is questionable whether such a system is appropriate or manageable in a larger economy such as Australia. The implementation of such a system might be more appropriately confined to SME taxpayers, but further analysis or modelling is needed on the relative benefits versus the potential implementation costs of adopting a cash flow tax system in Australia.

3.3 What tax should apply to distribution of profits?

Often, when we engage in debate on how the distribution of profits from a company are taxed, the fate of Australia's imputation system is always questioned. Debate centres around observations that most company tax systems have moved away from an imputation system, and the pressure point of the current system is the treatment of increasingly international operations of companies which reduce franking capacity.[14] Despite the debate, a compelling case for abolishing the imputation system in its entirety has yet to be established.

Some options considered include retaining the imputation system in its current form; removing the imputation system in return for a significant reduction in capital taxation; or modifications to the existing system such that it is modernised for globalisation.

Australia currently taxes dividend income at the marginal tax rate and an imputation credit is given to shareholders for corporate tax paid. Australia's dividend imputation system has served Australian taxpayers well in the past. The imputation system has been described 'a subsidy' on domestic savings and hence, it is unsurprising that Australian investors have a portfolio bias for franked dividends.

The current imputation system provides integrity benefits of providing incentives to pay Australian rather than foreign, company tax and reduced incentives to avoid tax. The current imputation system also removes the distortions that can arise in a classical system of taxation and also, provides a more neutral tax treatment between debt and equity finance.[15]

However, there is a need to shift thinking from how the past is apt to resemble the future, and instead consider whether modifications can easily be made for a change in circumstance, or whether more radical change to the imputation system is needed.

During the Asprey review, the argument for an imputation system in Australia stemmed from the need to address the 'equity' and 'efficiency' distortions of a classical company tax system combined with high progressive personal tax rates. The imputation system was seen as a solution to address the bias in favour of retaining profits and raising finance from corporate debt. Although the problems associated with a classical company tax system are still relevant today, the imputation system arguably works better in a closed rather than an open economy.

The emergence of globalisation and the openness of Australia to capital flows started to reveal perceived flaws in Australia's imputation system - namely, the inability of foreign shareholders to obtain access to imputation credits for tax paid in Australia and the inability for Australian investors to gain access to franking credits for taxes paid by Australian multinationals in relation to the derivation of foreign income.

It is difficult to conclude whether removing these tax barriers would influence behaviour such that more foreign direct investment is directed into and out of Australia, but such measures could matter where decisions between investment and regional holding locations are at the margin.

Whilst removing the tax bias would remove the perceived barriers for Australian multinationals investing offshore, it is questionable whether it is appropriate for Australia to unilaterally resolve this issue, in what really is an issue of international equity in tax sharing. It is interesting to observe in a recent OECD Economic Survey of NZ, an efficiency case was made for NZ to unilaterally recognised to provide imputation credits for Australian tax paid, even without reciprocal action by Australia. However, such a move would entail smaller benefits and a higher fiscal cost.[16]

[14] Smith, *Australian Tax Reforms: Past and Future* (February 2009)
[15] Australian Treasury, Australia's future tax system, Consultation paper, Chapter 6 p 137 (December 2008)
[16] OECD, *OECD Economic Surveys New Zealand,* Chapter 2 p 65 (2009)

As mentioned in our first submission, the removal of these distortions may be best advanced through bilateral or multilateral negotiations. For example, the recognition by the Australian and NZ Governments of a possible move towards mutual recognition of imputation and franking credits between companies that invest in each other's country would seem consistent with the approach.

The alternative approach noted in the consultation paper is to modify the current imputation system to permit dividend streaming to allow optimal usage of imputation credits. For example, favour streaming of (unfranked) foreign income to non-resident shareholders.[17] Such an option would involve less change and thus simpler to implement and reduce a bias at the resident shareholder level against direct investment offshore by Australian companies.

In addition, current rules that prevent 'dividend streaming' create legislative complexity and increase administrative and compliance costs.

Smaller Australian multinationals with a relatively small non-resident shareholder base may be disadvantaged under a 'streaming' approach as dividend streaming only benefits companies with non-resident shareholders. The extent of the benefits depends on the proportion of non-resident shareholders of an Australian company, foreign source income and the level of profit distributions.

There is some attractiveness in considering options for shareholder relief that are not dependent on the link between Australian company tax paid and the shareholder relief received. Some countries without a dividend imputation system provide a degree of tax relief at the shareholder level. Shareholder relief can take the form of applying lower rates of personal tax on dividends, providing a notional tax credit, or exemption part or all of a dividend from a shareholder's assessable income. These alternative approaches to shareholder relief provide a uniform tax treatment at the shareholder level for dividends paid by resident companies. Tax relief is given irrespective of whether domestic or foreign tax is paid or the underlying source of the company's income from which dividends are paid.

Our first submission suggested alternate company-shareholder integration systems be considered. Two mentioned in particular are Singapore's dividend exemption system and Norway's ASE system. These systems were evaluated in our first submission. Since then, we have had the benefit of discussing the practical aspects of these systems with our international offices to assist in evaluating whether the current imputation system should be replaced with an alternate system. Some of our findings of the practical observations are summarised below.

3.3.1 Singapore

Background

Under the former imputation system, tax paid was passed on to its shareholders in the form of a tax credit on payment of franked dividends. This was achieved through the 'Section 44 account mechanism' (broadly similar to Australia's franking account), unique to Singapore under section 44 of the Singapore Income Tax Act (SITA).

This provision obliged a Singapore resident company to maintain a Section 44 account. When a company was liable to pay corporate income tax, the tax was credited to the Section 44 account.

A section 44 charge occurred, where the debit to the section 44 account exceeded the credits to the account on the payment of a franked dividend. It was paid to the Comptroller within 14 days from the date of payment of the franked dividend. The charge could be used to set off any future tax assessment on the company at the normal corporate tax rate, but was not refundable.

A franked dividend was taxable in the hands of the recipient shareholder. They could however claim a credit for the tax deducted, against his tax liability. Any excess tax credit over the tax liability was refundable.

From 1 January 2003, Singapore changed corporate tax systems, from a full imputation system to a one-tier corporate tax system. Under the one-tier corporate tax, tax paid by a company on its income is a final tax. All dividends paid out of "after tax profit" by a company are exempt from tax in the hands of the shareholder. A company is not required to deduct tax from the dividend paid.

Singapore's objectives of introducing such a one tier system was to promote Singapore as an international hub for holding companies and reduce compliance costs.

[17] Australian Treasury, Australia's future tax system, Consultation paper, Chapter 6 p 140 (December 2008)

Under the one-tier system, tax assessed on a company on its normal chargeable income is a final tax. The section 44 account was abolished as at 1 January 2003, except for situations during the five year transition period to implement the one-tier corporate tax system.

Impact of the tax system on economic growth and tax revenue

The move to change Singapore from an imputation system to a one-tier system was proposed in the Singapore Budget 2002 and took place in the five transitional years following. Hence, any Ministry of Finance documents to supporting the proposed change and its revenue impact are likely to be attached to the budget papers.

The primary difference is that with the one tier system, there is no need to look at franking credits or the section 44 charge. Taxpayer companies use to be able to use franking credits to offset future income tax. This charge was almost like an advance payment or prepayment of company tax.

Impact of the tax system on profit retention

In Singapore, an imputation system created a disincentive for companies to distribute profits where they do not have sufficient imputation credits to attach to dividends. This aspect was seen as discouraging holding companies from using Singapore as a hub for regional activities.

We understand that since the introduction of the one-tier system, it has been easier for companies to distribute of profits, as companies no longer have to ensure they have sufficient franking credits.

However, under the one tier system, a major change is that interest expense on borrowings used to finance the investment in the company that derives one tier exempt dividends, cannot be deducted. This has meant that certain groups had to engage in more careful planning to ensure that tax efficiency is achieved in structuring the group's operations. For individuals, it is common practice for most individual investors in Singapore to buy shares with cash, not credit. Consequently, the removal of interest deductibility would not prima facie seem to have a huge impact for the broader population of investors.

Impact on returns to shareholders

The main group of taxpayers disadvantaged by the removal of Singapore's imputation system were retirees, mainly because the introduction of the one-tier system removed the deductibility of interest expense on borrowings used to fund the acquisition of shares.

The abolition of the imputation system was accompanied by the introduction of an exemption for interest income earned on all bank deposits. The exemption for interest income was introduced to reduce distortions in the way savings are taxed and to increase liquidity in domestic financial markets. This encouraged Singapore investors to liquidate their share portfolios and deposit the funds into bank accounts.

The impact on foreign direct investment (if any)

There has been no detectable impact on foreign direct investment in Singapore, as there has been no study conducted on the taxation of shareholders from overseas subject to Singapore's one tier corporate tax system.

Other considerations

By moving to a one-tier system, one issue that needed to be considered was whether Singapore needed to change its double tax treaties. This has not occurred so far. This issue still needs to be considered further but initial thoughts are that the introduction of a one-tier system should not have a major impact on Singapore's tax treaties.

Another issue that arose was whether share buybacks or other forms of capital reductions were a problem under a one tier system, in particular, in relation to the treatment of a deemed dividend amount. We understand that under Singapore tax law any excess over capital component is deemed a dividend. As the excess amount is deemed a dividend, this should be exempt under the one tier system.

The five-year transition period was more than sufficient time for the government to prepare itself for a new corporate tax system. However, if a company has not used its section 44 credits by the end of the five years, then they were lost in January 2008.

Under the imputation system this was previous limited to up to three tiers of shareholders. Now there is no limit. The one tier system allows the flow-through of exempt dividends to be for unlimited tiers of shareholders with no minimum shareholdings requirement.

A further issue is that with the introduction of the new corporate tax system, section 44 is no longer used. From a practical perspective, the one tier system has greatly reduced the workload for tax professionals as the system has been reduced in complexity.

3.3.2 Norway

Background

Norway previously had a corporate tax system, known as the dual income tax system (DITS). Under this system, dividends were taxable for the recipients, both individuals and corporate entities. The shares had a credit which was equal to the tax on the received dividend. Thus, the system almost resembled an imputation system.

The DITS was also characterised by a flat uniform personal tax on all forms of capital income levied at a rate equal to the corporate income tax rate. As capital income and labour income was subject to different tax rates, income splitting was mandatory in Norway under the DITS for entrepreneurs that carried out a certain minimum amount of work in their company and who had an ownership share of at least two thirds in the company. Even so, there was an incentive to convert labour income to capital income given that it was taxed at a much lower rate than labour income. Thus, individual taxpayers would split their income to capital income, in preference to the more highly taxed personal income tax.

This trend occurred in the 1990s and it was felt that the Norwegian income splitting system was undermining the integrity of the tax system and the problem needed to be addressed.

With effect from 1 January 2006, the imputation method of taxation for dividends is replaced by a modified classical system (ASE). The objective of the reform is to decrease the differences in levels of taxation of earned income and investment income.

The double taxation of corporate profits when distributed to individual shareholders is limited in the sense that all shareholders would be allowed a tax free dividend equal to a risk free interest (the annual average interest rate on the three month government promissory rate) on their tax base cost of each share. The regime is applicable to all investments in shares both in Norway and abroad and also applies to investments in controlled foreign companies (under a complicated technical formula).

The tax base cost for the purposes of the new tax regime is equal to the acquisition cost of each individual share, adjusted for retained taxed profits allocated to that share prior to the introduction of the new tax regime.

Individual shareholders are taxed on their dividend income exceeding an amount equal to a risk free interest, on the tax base cost of their shareholding. The tax free amount is assessed on each individual share, rather than on the portfolio. The combined tax on corporate profits and shareholders equals 48.16 percent under the regime. Unused tax free amounts may be carried forward and set against future dividends or gains on the same shares, but cannot be used against dividends and gains on other shares.

Impact on tax revenue

We understand it is difficult to tell whether there has been any change in the corporate tax revenue, as a substantial portion of Norway's revenue from corporate entities is from petroleum. However, it appears that tax reform has increased the tax on dividend distributions.

We were unable to obtain this information, however, our KPMG office in Norway is able to obtain this information through their contacts with Norway's Ministry of Finance if this is required.

Impact of the ASE on complexity of the taxation system

We were advised that many businesses in Norway prefer the former system because it is easier to use and less complex, especially with separating between capital and personal income.

Under the ASE system, individual taxpayers find it difficult to complete a tax return every year as a Norwegian company has to deliver information each year regarding share capital. This can be complex if the taxation authorities believe the information is incorrect. However, they are currently working on building a register with the relevant information.

Furthermore, there are issues with correctly calculating the cost base of the shares. If a company does not get the cost base right and sends the incorrect information to the individual taxpayer, the individual taxpayer 's tax returns will not be correct either.

Investor preferences and impact on foreign direct investment

There has been no obvious impact on increased preferences to share investments instead of other asset classes. For individual taxpayers, investing in property has been preferred due to concessional taxation on capital income.

Also, there has not been any obvious measurable impact on foreign direct investment as a result of the introduction of the ASE system. However, what has been obvious is the increase in complexity of implementing such a system.

3.3.3 Considerations in an Australian context

There is some attractiveness in adopting the Singapore tax system in providing shareholder relief for tax paid at the corporate level. Both the objective of preventing double taxation of the same profits and simplicity are achieved under Singapore's one tier dividend system. The downside, however, is the elimination of interest expense in relation to funding of shares giving rise to exempt dividend income. Whilst this might not have been a major issue in Singapore for the broader population, further analysis will be needed to determine the impact of adopting such a proposal in Australia. Whilst certain taxpayers (e.g. superannuation funds and tax-exempt entities) may be disadvantaged by the removal of Australia's imputation system, consideration may be given to providing an exemption for interest income on bank deposits in an attempt to encourage savings in Australia. However, an issue that should be subject to further debate is whether retirement incomes policy should unduly influence the architecture of the corporate tax system.

Based on the Norwegian experience, the ASE system would appear to result in high compliance costs. Whilst to some extent double taxation may be avoided under this system, it does come at a cost of increased complexity. Ideally, a corporate-shareholder integration system should achieve both objectives of equity and simplicity. Thus, the ASE system as adopted in Norway would prima facie be unattractive from an Australian perspective.

4 Recommendations

The design of a new corporate tax system in Australia requires consideration of the appropriate statutory rate; tax base and determining how distribution of profits is to be taxed.

The recommendations below are based on the assumption that economic growth is associated with lower levels of capital taxation in the overall revenue mix; the tax system should be simple from a compliance perspective; equitable, in the sense that profits are not taxed twice; and a bias is not created between debt and equity or conducting operations in Australia versus offshore.

As noted above, there is yet to be a compelling case for removing Australia's current imputation system and the AFTS panel needs to engage in further analysis and modelling to see whether such a case can be established. We are happy for the AFTS panel and Treasury to engage with us and our international offices to further explore the practical consequences of adopting these systems.

4.1 Recommendation 1- what is the appropriate statutory rate?

The company tax rate is the most visible feature of the business tax system of a country. It is a feature that attracts considerable attention as many investors may regard the tax rate as an indicator of other aspects of the business tax system.

Australia should have an aspirational goal of reducing the corporate tax rate from 30 percent to 20 percent with an interim rate of 25 percent

4.2 Recommendation 2 - What is the appropriate tax base?

An ACE system is attractive from the perspective of achieving neutrality between debt and equity funding. Achieving this neutrality removes the complexity of the currency debt/equity provisions and the thin capitalisation provisions in Australia's income tax law.

If Australia considers implementing an ACE system for corporate taxpayers, there are questions as to how an ACE system would be funded. For example, further consideration needs to be given on whether a reduction in the corporate tax rate can be achieved at the same time, through recalibrating the taxation mix such that greater reliance is placed on indirect taxes. In addition, it would be unfortunate if an ACE system is introduced at the expense of the dividend imputation system.

Moreover, consideration needs to be given to setting an appropriate rate for the notional interest deduction under an ACE system. As Australian businesses become more globalised and exposed to greater funding in foreign currency, setting a notional deduction rate that is a 'one size fits all' will be difficult to achieve and will require constant monitoring by the revenue authorities. As noted in the Belgium experience, this has proved to be a challenge and has required Belgium companies to become more proactive in their hedging strategies.

If Australia considers adopting a cash flow tax system, this would require a fundamental shift in the taxation of business and implementation costs would be high. Whilst there are clearly benefits of a cash flow tax system as experienced in Estonia, it is questionable whether such a system is appropriate or manageable in a larger economy such as Australia. The implementation of such a system might be more appropriately confined to SME taxpayers, but further analysis or modelling is needed on the relative benefits and potential implementation costs of adopting a cash flow tax system in Australia.

4.3 Recommendation 3 - what tax should apply to distribution of profits?

As noted above, there is yet to be a compelling case for removing Australia's current imputation system and the AFTS panel should conduct further analysis and modelling to see whether such a case can be established.

There is some attraction in adopting the Singapore tax system in providing shareholder relief for tax paid at the corporate level from a simplicity perspective.

However, greater equity is attached to Australia's current imputation system than under a one tier dividend exemption. This arises because imputation credits are refundable to certain entities such superannuation funds and tax-exempt entities.

A major drawback of Singapore's one tier system is the non-deductibility of interest expense in relation to funding of shares giving rise to exempt dividend income. Further analysis will be needed to determine the impact of adopting such a proposal in Australia. Whilst certain taxpayers (e.g. superannuation funds and tax-exempt entities) may be disadvantaged by the removal of Australia's imputation system, consideration may be given to providing an exemption for interest income on bank deposits in an attempt to encourage savings in Australia. However, further debate is needed on whether it is appropriate for retirement income policy to influence a new framework of a corporate tax system.

Based on the Norwegian experience, the ASE system would appear to result in high compliance costs. Whilst to some extent double taxation may be avoided under this system, it does come at a cost of increased complexity. Ideally, a corporate-shareholder integration system should achieve objectives of equity, efficiency and simplicity. Thus, the ASE system as adopted in Norway would prima facie be unattractive from an Australian perspective.

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