Limiting Taxpayer Subsidies of Excessive Executive Remuneration, High Risk Business Borrowing and Labour Liabilities Through Tax Deductibility Conditions and Limits

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As Dr Henry conducts his review of the taxation system in the sobering glare of the global economic crisis, it is proper to consider how the taxation system might be used to protect taxpayers and government budgets from the high costs of profligate executive remuneration, excessive and reckless business borrowing, and corporate failure to fund full worker entitlements. All of these costs have become more significant as Australia's economy and revenues suffer the impact of the global recession.

But before I suggest some tax deductibility changes and limitations for businesses, I need to address the inevitable threats that companies adversely affected by such changes and limitations will likely cart out as part of their objections, e.g., threats about companies moving off shore, closing down or avoiding Australia as a base of operations and losing jobs. I don't buy these threats for a minute.

Decisions about where to set up shop are made far more on the basis of a qualified workforce, production and distribution costs, and political and economic stability of the country. Australia is arguably four-star in at least two of these areas, and its corporate tax rate is highly competitive.

How can companies rationally argue that limited tax deductibility on their remuneration and borrowing costs forces them to move to a country that encourages them to pay excessive salaries and bonuses and high interest rates? If they can't afford a little less tax deductibility, how can they afford exorbitant remuneration and high interest? And how can they afford to relocate?

I encourage Dr Henry and his team to consider what I suggest without fear of those empty threats and with an open mind. It is easy for experts to dismiss new ideas by coming up with reasons why they can't work. But a true expert will welcome the challenge of thinking how these ideas can be made to work.

Executive Remuneration: Taxpayers subsidise excessive executive and board remuneration packages through tax deductibility of those payments. Given the vehement opposition to such excesses within both the community and government, Dr Henry's review should look at how much revenue Australia loses through that deductibility and place limits on the deductibility that reflect government and community views on what is appropriate and deserved and what is excessive. Australian taxpayers and governments are well within their rights to say how much they are prepared to subsidise and under what circumstances.

With this in mind, *I recommend a $500,000 cap on tax deductibility of executive remuneration,* including salary, superannuation over the statutory requirement, bonuses, share issues, termination payments, salary sacrifice and perks like private-use cars, personal or family accommodation, gym memberships, school fees, and non-essential office or home renovations.

The approach has been criticised on the basis that when the US introduced such a cap on salaries, other forms of remuneration increased to make up for it. This is not possible in this case because everything a company gives to an executive for personal use, benefit, reward or enjoyment counts as remuneration. Just because an executive wants a gold-plated executive toilet or a car for his wife or an apartment in another city or a weekly flight home, the taxpayer should not be up for 30% of the cost.

Taxpayers get no benefit from a company's largesse to its executives and are perfectly entitled to set a limit on their subsidy of the costs of executive remuneration. Companies can still pay whatever they like, but it comes off their bottom line, not out of taxpayers' pockets. To sweeten this cap for business, fringe benefits tax (and all its administrative nightmares) could be abolished for anyone receiving remuneration more than $500,000.

I also suggest that executive and board remuneration not be tax deductible at all after three years of operation if the company is not producing a profit. Three years is enough time for a new company to turn a profit. Older companies with bad balance sheets, high costs, overloaded with debt and under-capitalised should not be rewarding executives who put them in that position or can't get them out of it.

This requirement ensures highly paid individuals are motivated to create business success, which is good for the economy generally, before taxpayers subsidise their remuneration. If companies elect to operate businesses that only produce losses to minimise taxes elsewhere, then the taxpayer should not be making any contribution to their executive and board remuneration.

A limited exemption might be granted to start-up technology, manufacturing or resource companies that might take a few years to turn a profit, but deductible executive remuneration should be more modest until they do, say, $100,000 per executive and no deductibility for board member payments after three years.

I also think it is reasonable to introduce a new tax rate for remuneration above $500,000. I think this should be $202,000 plus 50 cents for everything over $500,000.

Borrowing: Taxpayers subsidise business borrowings through tax deductions for interest payments. A lot of blame for the current economic crisis can be sheeted home to reckless borrowing, but Australian taxpayers are forced to subsidise that borrowing without limits and without any benefit or input. Dr Henry's review should quantify what such tax deductions cost Australia's budgets and taxpayers, and set limits and conditions on those deductions.

I base my suggestions on the principles (1) that only businesses that provide goods and services or that are primary producers deserve interest tax deductions, and (2) that such deductions should only be available for interest on borrowings directly related to the core business, not on borrowings for speculative investments outside the core business. The idea is that taypayers subsidise only borrowings that increase the productive capacity of businesses and contribute to national economic productivity rather than just churn capital through market manipulation and speculation. That churning is what created the false sense of prosperity and growth that inflated real estate and share market bubbles. Therefore, I suggest

- Interest deductions on operational borrowings be capped at a percentage of turnover or income.

- Interest deductions on capital borrowings be limited to investments in income-producing plant, equipment and infrastructure.

- No interest deductions for real estate purchases unless the core business is property development or management or real estate trading.

- No interest deductions for investments in shares or financial instruments unless the core business is buying and selling shares and/or financial instruments.

- Interest deductions on borrowings for acquisitions be limited to 12 months, after which borrowings are classed as operational and subject to limitations above.

- All interest deductions be capped at a market rate of interest.

Operational Borrowing: I suggest that deductibility of interest on borrowing for operational expenses be capped at a percentage of turnover/income, to ensure that borrowing to cover fixed and variable costs does not exceed the trading value of the business. Such a business would be a bad proposition and should not be operating, but that is a decision for the business to make. But taxpayers should not be subsiding an over-extended enterprise that is not generating enough income or is not using its income to cover its expenses.

I base this suggestion on an example that I recently heard on a PBS TV report on the effect of the credit crisis on small business. It illustrates how out-of-whack business thinking has become in an era of cheap credit. A restaurateur was bemoaning the fact that his bank had withdrawn his line of credit, despite him having $100,000 per week in turnover. He said without the line of credit, he could not pay his staff or buy food for his kitchen. One has to ask what the $100,000 a week cash flow was being used for if not to cover his operating expenses. Perhaps to pay for his Porsche and Malibu beach house.

If businesses use credit instead of cash flow to meet their recurring expenses, taxpayers should not reward that borrowing with tax deductibility, apart from what is necessary to smooth out the cash flow of a business.

Capital Investment: I also suggest that deductibility of interest for capital borrowing be limited to investment in income-producing assets like plant, machinery and infrastructure. Interest on such borrowings should have no deductibility cap, to encourage investment in corporate productivity and competitiveness. Interest on borrowing for company cars should only be deductible for cars used primarily for business purposes and the amount deductible should be capped at the interest payable on financing a mid-size Australian-made vehicle. Companies that can afford to give executives luxury vehicles can absorb the extra interest costs as well.

Speculative Investment: Interest tax deductibility should not be extended to borrowings for speculative investments in shares and financial instruments unless such investments are the core business of the enterprise. Such investments remove from a business funds that may be better spent on training, innovation or improving productivity. They do not grow the economy or jobs but merely churn capital, or as recent history has taught us, destroy businesses and investors. They are not part of the core business to which tax deductibility is granted. If companies want to pursue such investments, they can set up discrete entities to do so, which may then give them tax deductibility entitlements but without endangering the other enterprise.

Real Estate: Borrowing to purchase real estate should not be tax deductible unless one is a property or mining business. It is a general principle of business that one does not buy a building that it can lease, to preserve its capital and increase its tax deductions. Like investments in the market or financial instruments, buying real estate unnecessarily sucks productive capital out of a business, and it is not part of the core business to which tax deductibility is granted. Again, if an entity wants to buy real estate, it can set up a discrete entity for this purpose and claim tax deductibility. Small businesses should not be able to deduct interest for mortgages on home offices or business premises in which they live.

Acquisitions: I suggest that deductibility of interest for acquisitions be limited to 12 months, which gives the company time to integrate the acquisition. After that time, any interest payable on the acquisition loan should be paid out of the cash flow the acquisition generates and should be treated as an operational expense subject to limits outlined above. If you buy a business that isn't going to produce enough cash flow to cover your interest costs and increases in fixed and variable costs, then it is a bad acquisition. The government can't stop businesses making bad acquisitions, but it can stop taxpayers subsidising them indefinitely.

Market Rates: We have learned from this crisis that many companies borrowed too much at rates they couldn't afford, and lending institutions were pretty slack in assessing companies' ability to repay loans. The resulting fallout means that lending institutions, at least, are likely to be much more risk averse and to charge premium interest rates on risky business lending. Taxpayers should not have to subsidise the high interest costs of risky borrowing.

I suggest that tax deductions for business borrowing be capped at the average market rate for low-risk business borrowing. If companies have to pay higher interest rates because they are more financially risky, taxpayers should not reward their risk-taking by allowing more generous deductions than the companies would be entitled to if they were more financially sound or cautious. Taxpayers should not subsidise risky investments or marginal businesses more than it subsidises quality businesses borrowing sensibly for good reasons. Hence the cap on deductible interest rates. And lenders do the risk assessment, which is reflected in the interest rate charged, so the ATO doesn't have to make any complex judgements.

The same cap on deductible interest rates should apply to real estate and share market investors. Interest deductions for investment properties or shares should be capped at 50 points above the average variable mortgage rate. Foolish investors who take out loans at high interest rates to speculate in the market or on real estate should not be subsidised by taxpayers.

Labour Liabilities: When companies fail to put aside money for their contractual and award obligations to ordinary workers -- e.g., holiday and sick pay, long service leave, redundancies and super -- taxpayers pick up the tab through the government redundancy fund, Centrelink benefits and pensions. The government must protect taxpayers from such obligations.

I suggest that the tax deductibility of any labour costs be contingent on full payment of all workers' entitlements, as they accrue, into an Employee Benefits Trust not under the business' control, and all workers' super entitlements into an approved fund. Without evidence of having paid all such worker entitlements, no tax deductions for labour costs should be claimable.

The government may also want to set up an ATO master trust into which small businesses can deposit their entitlements through the PAYE system. Governments should also refuse to trade with any business that is not fully paid up on its employee entitlements.

Companies are quick to claim they cannot possible afford to put aside funding for their contractual and award obligations to ordinary workers, yet they insist they must meet their contractual obligations to pay multimillion-dollar bonuses and termination payments, even to executives who have driven the company into a ditch. Too many companies will not do the right thing until they are forced to. I'm sure business would find tax deductibility of labour costs too valuable to risk by avoiding their obligations to workers. And this does not add one cent to the cost of labour. It only pays workers what they are due.

Making the tax deductibility of labour costs contingent on fully funding employee entitlements is taxpayer protection and also simple good business. If a business cannot meet its full financial obligations to its workers, it should not have workers. It is not the employees' responsibility to fund the employer just to have a job. That's indentured servitude. The idea that workers should put at risk their entitlements for no benefit is another form of servitude, with an employer using employees' funds without their consent or benefit.

An Employee Benefits Trust and better ATO monitoring of statutory superannuation contributions will provide valuable protection for taxpayers and workers while teaching companies to be responsible to their workers.