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The Institute of Chartered Accountants in Australia

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

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Foreword

Few issues excite stronger reactions and have broader impacts than taxation. Recent global financial market developments have helped to highlight the importance of preparing Australia's economy to withstand the rigours of the 21st century. The Government is to be congratulated on reopening the tax reform debate by setting up the Australia's Future Tax System Review to evaluate the best way forward for our tax-transfer system.

During our initial work on this submission, it became clear that given the deadline we would not be able to conduct a detailed examination of opportunities to reform all sections of the Australian tax and transfer system, so we have focused on those areas we believe will have the greatest impact on the future prosperity of the nation.

The corporate tax regime could be considered as 'just' a source of revenue to help fund the transfer system and other government programs, but this fails to account for the role it plays in supporting Australia's ability to compete for capital in the global economy and thereby drive economic growth. In this submission, we have focused on how Australia could potentially improve productivity and drive growth through reforms to the taxation of business. This includes looking beyond our borders to analyse various corporate tax regimes around the world and the pros and cons of each of these in comparison to the current Australian system, including an examination of the impacts of Australia's reliance on the taxation of capital income.

This examination of the taxation of capital income would not have been complete without an examination of the corporate tax rate. It seems clear the advantage that Australia once held in this area has been eroded as other countries have moved to attract global investment through corporate tax rate reductions. Australia's corporate tax rate is now above the global average, which leaves us with questions regarding whether this is acceptable given global competition for capital.

This submission also looks at the level of complexity Australian businesses face within our own national borders, particularly with regard to state-federal interactions, and the impact this has on certainty and compliance.

We acknowledge the work of the Institute's Tax Counsel, Ali Noroozi and the rest of the Institute team for the time and effort they have invested in the production of this document. We also thank the following key KPMG contributors for their insights: Rick Asquini, Marco Di Sebastiano, Michael Evans, Ian Farrow, Fiona Giuseppi, Matt Hayes, Rod Henderson, Andy Hutt, Janelle Swann and Jenny Wong.

We look forward to providing further input into this vital reform program, and would be pleased to further discuss any of the areas covered in this joint submission.

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Executive Summary

'Tax reform' was once described by the late Justice Graham Hill as the 'Tower of Babel'[1] - a metaphor that tax reform means different things to different people. To us, tax reform means an opportunity to critically examine the options for reshaping Australia's tax system to better accommodate the evolving dynamics of Australia's social and economic environment. The end product should be a tax system that is internationally competitive and optimises economic growth and living standards for all Australians in the long run.

The Australia's Future Tax System Review provides an opportunity to address long-term structural issues in the Australian tax-transfer system. In this submission, the Institute and KPMG focus principally on options associated with reforms to the taxation of capital and in particular reforms to the Australian corporate tax system.

As the Architecture Paper notes, it is "a surprising result in a globalising world with increasingly mobile capital flows for a small open economy to have the highest weight given to the taxation of capital income". Australia should be considering how it taxes the return on capital, and assessing whether we have the right incentives for individuals to provide for their future and to provide capital to businesses. For example, the current Australian system of taxing interest bearing deposit accounts potentially warrants further consideration.

Australia's corporate sector is a key contributor to the capital taxation base and a key driver of growth in the Australian economy. The extent to which the corporate sector is taxed and how such tax is imposed are critical issues in shaping Australia's future tax system.

In analysing the Australian tax system we find the burden of taxation has, in more recent years, been increasing on the corporate sector. Australia's corporate tax burden is becoming increasingly uncompetitive when compared to other countries.

Australia's corporate tax base is broader than many other industrialised economies. Whilst we consider that a broad tax base is more desirable than a narrow tax base, the broadening of the corporate tax base in the period following the Review of Business Taxation in 1999 has contributed to the increasing burden of corporate tax.

Australia's statutory corporate tax rate has remained unchanged since 2001 while the rest of the world, in particular the OECD member countries, has taken the initiative and progressively reduced corporate tax rates. The global trend in corporate tax rates over the past seven years has been for reductions and Australia should consider a decrease in the corporate tax burden to maximise its opportunities for future productivity growth.

We propose an aspirational goal of reducing the corporate tax rate from 30 percent to 20 percent and a rate of 25 percent as an interim measure. Of course, consistent with tax reform being an examination of potentially competing options, the cost/benefit analysis of this goal needs to be assessed against other tax reform options. A review of any corporate tax rate reduction should model the immediate revenue cost against the longer term investment, economic and revenue benefits. The outcomes of this modelling should be compared and considered along with other reform options.

This aspirational goal in relation to the corporate tax rate is consistent with a fundamental objective of reducing the tax on mobile income.

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[1] Hill, G, 'Tax Reform: A Tower of Babel; Distinguishing Tax Reform From Tax Change', *Journal of the Australasian Tax Teachers Association* (2005)

We have considered, in principle, the sustainability of the Australian dividend imputation system. Australia's dividend imputation system has many positive attributes in terms of mitigating equity and efficiency concerns in relation to domestic double taxation of dividend income, encouraging the distribution of dividends, promoting capital market efficiency, and advancing investment in local equity markets. It also brings compliance benefits, as the ability of Australian shareholders to earn franked dividends provides companies with an incentive to maximise their taxable profits in Australia.

However, it is recognised that the current dividend imputation system could be improved. In particular, for Australian companies with substantial overseas operations, imputation relief is not provided in respect of foreign source income.

The dividend imputation system has served Australia well in the past and a comprehensive case for its abolition has not yet been made. Rather, potential enhancements to Australia's dividend imputation system should be considered in the light of the experience of other countries' tax systems.

In searching for international best practice on the taxation of capital income, we have examined the features of a number of other tax systems. In this regard, we have examined the allowance for corporate equity, shareholder allowance for corporate equity, allowance for shareholder equity, a comprehensive business income tax, dual income tax, the flat tax and the corporate cash flow systems. Some of these tax systems have been tested and implemented in some countries. While not making specific recommendations for the adoption of a particular model for Australia, these alternate systems do demonstrate the development in international thinking on the taxation of capital income that is becoming increasingly mobile in a globalised economy. For example, a dual income tax system provides the flexibility of combining a lower flat tax on capital income with a progressive rate on labour income. Similarly, the allowance for corporate equity tax system is attempting to only tax those profits in excess of a 'normal' profit consistent with taxing capital income concessionally. The allowance for corporate equity tax system also seeks to mitigate the distortion between debt and equity financing and potentially reduces the need for complex debt/equity and thin capitalisation provisions. All these tax systems have a core goal of encouraging mobile capital investment. Whilst a wholesale change to Australia's tax system may ultimately not be feasible, there are features within these other systems that should be considered.

A tax system can be evaluated both conceptually and by reference to the 'friendliness' of the tax system; measured in terms of complexity, transparency of the taxation administration, and a willingness to continuously revise and improve in line with a country's changing needs.

Thus, Australia would benefit from greater co-ordination in dealing with the interdependencies between taxation outcomes and other regulatory reforms affecting capital markets such as corporations law. In addition, with Australia adopting International Financial Reporting Standards as a single reporting language for the capital markets, greater alignment between tax and accounting would potentially reduce compliance costs. Such initiatives would promote a greater degree of harmonisation across regulatory frameworks.

The relationship between the Government and the States/Territories has changed significantly since Federation, with the ceding of income tax powers to the Government in the 1940s leading to a progressive decline in the revenue base of the States/Territories. As we believe economic authority properly resides at the national level of government, we do not propose measures to reverse this trend. In fact, we recommend that some of the taxes currently levied by the State/Territories might be eliminated, with others consolidated at a national level on a similar basis to the goods and services tax. Moreover, for taxes that continue to be administered at a state/territory level, further harmonisation of those tax systems across Australia should be encouraged.

In respect of personal income tax, the Government's previously announced aspirational goals for personal income tax may need to be fine-tuned having regard to any reduction in the corporate tax rate. Consideration should also be given to adopting the international taxation norm of taxing fringe benefits in the hands of employees, rather than the employers.

We have considered the issue of mandatory superannuation contributions. Whilst previous Department of Treasury retirement income modelling suggests that a nine percent rate is sufficient, we believe it would be worthwhile revisiting these earlier conclusions.

Climate change has been a catalyst not only for environmental and related policy settings but also has a place in the context of tax reform. It has a direct impact on the existing tax policy settings which may now need to be re-aligned in view of the Government's environmental objectives. Areas that need to be reviewed in this context include, for example, the taxation regime for motor vehicles, as well as enhanced capital allowances and other tax incentives for carbon capture storage and low emissions technologies.

Our approach to this submission and the review of Australia's Future Tax System is to focus on a key driver for Australia's future economic prosperity, namely, the corporate sector. The economic prosperity derived from this key driver are the resultant benefits to the economy and the population at large. The development of a vibrant corporate sector with strengths across a broad range of industries requires us to critically analyse the taxation of capital income. We need to look beyond state and national borders to ensure we have the right balance between an internationally and regionally competitive tax system and a sustainable revenue base for Australia.

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 Introduction

In May 2008, the Government announced it would conduct a comprehensive review of Australia's tax-transfer system. The AFTS Review will encompass Federal and State/Territory taxes, except the GST, together with interactions with the transfer system. The AFTS Review will involve consideration of:

- the taxation of savings, assets and investments, including the role and structure of company taxation
- the balance of taxes on work, investment and consumption and the role for environmental taxes
- further enhancements to the tax-transfer system for individuals, families and retirees
- the taxation of consumption and property and other State taxes
- simplifying the tax system, including the interactions between Federal, State/Territory and Local Government taxes and
- interrelationships between the elements of the tax system, as well as the proposed ETS.

On 6 August 2008, the Architecture Paper was released. It was designed to promote public discussion and a common understanding of Australia's current tax-transfer systems in the context of the demographic, social, economic and environmental challenges of the 21st century. On 19 August 2008, the Review Panel called for initial submissions as part of the broad strategy for consulting with the Australian community on tax policy review priorities.

KPMG and the Institute applaud the Government's commitment to the challenge of undertaking such a comprehensive review. Tax reform needs to be developed within the framework of enhancing economic performance, productivity and competitiveness, but it should also meet the objectives of being fair, efficient and transparent.

We appreciate the opportunity to provide an initial submission as part of the AFTS Review. We trust that our submission will assist in the development of a consultation paper to be prepared and released by the Review Panel before the end of 2008. We support the aims of the AFTS Review, namely to:

- develop a tax-transfer system that will play a key role to meet the challenges to secure Australia's future prosperity and the living standards of Australians
- harmonise and simplify taxes
- reduce inefficient taxes
- ensure a progressive tax system and
- address negative interactions with the transfer system.

Given these ambitious goals, we believe it is unfortunate GST has been excluded from the AFTS Review. Whilst our submission has been prepared consistent with the terms of reference for the AFTS Review, we do consider the completeness and effectiveness of the tax reform options available to Australia are constrained by the decision not to revisit the GST tax base or rate.

This submission does not seek to comment on tax initiatives that are part of pre-existing consultation processes or have been the subject of earlier submissions. For example, the Minister for Small Business, the Hon. Dr. Craig Emerson announced on 11 June 2008 that the Government will consider the Institute's earlier joint submission on EFT[2], to simplify small business taxation and reduce small business compliance costs. We also note Australia's climate change initiatives, particularly the proposed Australian ETS is subject to a separate review process. The Institute's joint submission on the tax policy issues for the ETS[3] has already been lodged.

In the limited time available to consult on the AFTS Review, our submission takes the opportunity to explore the options associated with:

- the taxation of capital income in an international context
- reforming Australia's corporate tax system to enhance productivity and competitiveness in Australia
- addressing the complexity of existing corporate taxation systems and
- achieving efficiency improvements in the context of federal and state/territory taxation arrangements.

We believe these areas are key tax policy review priorities for Australia. This submission therefore concentrates on the following areas of the terms of reference for the AFTS Review:

- Enhancing the taxation of savings, assets and investments, particularly the role and structure of company taxation. Our submission includes a discussion of where Australia stands internationally, on the taxation of capital income and the corporate tax burden, a review of Australia's dividend imputation system, an analysis of alternate corporate tax systems around the world and explores Australia's corporate tax rate aspirations.
- Simplifying the tax system. Our submission discusses the recent trends in the convergence of financial reporting and other capital market reforms and notes there are efficiency benefits to be obtained from revisiting our existing tax reporting procedures. Recent developments in tax policy and tax legislation design are analysed and further recommendations are made.
- Enhancing the taxation arrangements, including the forms of taxation collected primarily by the States/Territories. Our submission observes the multiplicity of similar taxes that exist within Australia's national borders and the opportunities that exist to consolidate and/or harmonise tax systems, as well as potentially change the way that fringe benefits are taxed.

We also briefly discuss the current levels of superannuation contributions and the implications of the Government's climate initiatives for existing tax policy settings.

This submission also seeks to summarise a number of our observations in the context of the Review Panel's high level framing questions around Australia's existing tax-transfer systems, in the context of the challenges Australia faces in the 21st century.

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[2] Institute of Chartered Accountants in Australia and Deloitte, *Entity Flow Through (EFT) Submission*, Institute of Chartered Accountants in Australia (2008)
[3] Institute of Chartered Accountants in Australia and Ernst & Young, *Australia's Proposed Emissions Trading Scheme - The Tax Policy Dimension*, Institute of Chartered Accountants in Australia (2008)

2 The framing questions

In response to the Review Panel's high level framing questions released as part of the AFTS Review consultation process, we outline below our observations on these questions with a focus towards corporate taxation. These observations provide an overarching framework for our detailed submission and recommendations that follow.

What major challenges facing Australia need to be addressed through the tax - transfer system?	What features should the system have in order to respond to these challenges?
Economic - Globally competitive tax regime (e.g. Australia faces increasing international pressure particularly for the taxation of capital, Australia needs a business friendly tax regime for inbound and outbound investment and for a mobile workforce) - Foster new businesses and diversity of markets (e.g. develop new commercial activity that will augment Australia's prosperity post the terms of trade boom) - Ageing population (e.g. likely to affect participation and productivity levels, economic growth, and ultimately the standard of living)	- The company tax and personal tax regimes should be internationally and regionally competitive - Tax collection and tax compliance use pre-existing reporting procedures or data collection processes - The tax system should encourage innovation and invention
Government services - Business deregulation (e.g. the retention of multiple forms of taxes/charges and tax concessions is inconsistent with deregulation) - Increasing demand for public services (e.g. health care, education, housing, vertical imbalance issues between Federal/State)	- A sustainable revenue mix (e.g. income, consumption and environmental taxes) exists to support the requisite public services and standard of living - The revenue mix has streamlined processes across Australia - The revenue (and tax concession) mix has a more cohesive design
Demographic/social - Workforce participation levels (e.g. ageing population, part-time participation) - Workforce skill levels (e.g. productivity, internationally sought after workforce, skills commensurate with changing business needs)	- The tax-transfer system rewards people to work (and work longer) - The tax-transfer system needs to encourage self-funded retirees given the ageing population
Environmental - Climate change response (e.g. income, consumption and environmental tax interactions are addressed)	- The ETS taxation system is 'best practice' in terms of, competitiveness, simplicity and efficiency - Tax policy settings are aligned with the Government's environmental objectives

What are the problems with the current system?	What reforms do we need to address these problems?
Historical settings - Reflects historical policy responses that were often ad hoc and reactive rather than forward looking with less focus on our international competitiveness and developed with minimal regard to other regulatory regimes - Tax reform initiatives were often constrained by considerations of maintaining 'revenue neutrality'	- Options still exist to broaden the tax base and lower rates. In addition, opportunities exist to reduce the number of different tax regimes, enhance their cohesion as well as reduce their complexity

3 Reforming Australia's corporate tax system

As Australia faces the demographic challenge of an ageing population, framing policy around three key areas of 'population, participation and productivity' (the '3Ps') appears to be reasonably well accepted. Policy design around these areas is needed to promote Australia's future economic growth.[4] Needless to say, policy choices adopted today should be sustainable in the long run and go beyond reforms to Australia's taxation system.

In recognising an ageing population in the next 40 years will reduce the labour force participation rate and thereby diminish productivity and economic growth[5], the focus in the past has been on reductions in personal income taxes aimed at enhancing incentives to work and thereby increasing participation in the Australian labour market.[6] With aspirational personal income tax goals in mind, the Government's terms of reference will mean that the AFTS Review will need to be cognisant of the personal tax rate goals, but should not be constrained by them.

Since the RBT in 1999, there has been very little debate on corporate tax reform[7] and whether further corporate tax reform initiatives can play a part in enhancing the third aspect of the '3Ps' – productivity. Higher productivity levels result in higher incomes, savings, investment and future growth in living standards in the long run.[8]

It has been recognised[9] that resources will move to areas of highest return, creating a strong incentive for people to build their skills and to invest in better processes and new markets. Productivity gains have been realised from other policy reforms of the past, which have created and opened up markets domestically and internationally in products and services, labour, natural resources and finance[10]. It is important to ensure taxation of capital does not hinder future productivity gains.

The Architecture Paper reports that the weight given to the taxation of capital in Australia is amongst the highest in the world. This surprising result is somewhat alarming, given Australia's position as a small open economy seeking to compete in a global economy with increasing capital mobility.

There are alternate ways in which some countries deal with the taxation of capital. For example, some countries have sought to tax capital income at a lower rate than labour income through a 'dual income tax' system, such as the Nordic countries. Countries such as Singapore have recently decided to discard a full imputation system in favour of a one tier

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[4] Gruen, Dr N, *CEDA Information Paper 85,Tax Cuts to Compete - The influence of corporate taxation on Australia's economic growth*, Committee for Economic Development of Australia (CEDA) (2006); Kingston, G, 'Tax Reform: A Different View', Proceedings of the 35th Australian Conference of Economists, Curtin University of Technology, Perth (2006)
[5] Australian Government, *Intergenerational Report 2007* (2007); Australian Government *2008-09 Commonwealth Budget – Budget Paper No.1: Budget Strategy and Outlook 2008-09* (May 2008)
[6] Treasurer, Wayne Swan 'Budget Speech 2008-09', Speech delivered on the second reading of the Appropriation Bill (No. 1) 2008; former Treasurer, Peter Costello 'Budget Speech 2007-08', Speech delivered on the second reading of the Appropriation Bill (No. 1) 2007-08 on 8 May 2007 (2007); former Treasurer, Peter Costello 'Budget Speech 2006-07', Speech delivered on the second reading of the Appropriation Bill (No. 1) 2006-07 on 9 May 2006 (2006)
[7] Davidson, S, *Executive Highlights No 655, Corporate tax needs attention now,* The Centre for Independent Studies (7 August 2008)
[8] Australian Government, *2003-04 Commonwealth Budget – Budget Paper No.1: Budget Strategy and Outlook 2003-04* (May 2003)
[9] Australian Government, *Intergenerational Report 2007* (2007)
[10] Australian Government, *Intergenerational Report 2007* (2007)

dividend exemption system for corporate and shareholder taxation as well as seeking to exempt certain interest income from taxation.

Other countries such as Belgium have sought to allow corporate entities a deduction for an imputed return on equity as a way of taxing the capital income of companies concessionally. The merits of adopting alternate taxation of capital income regimes (particularly alternate corporate tax systems) have recently been reviewed by countries like the UK.

Understanding the reasons behind these international developments may guide Australia in formulating appropriate tax policies in relation to the taxation of capital income.

As the corporate tax burden is the most visible aspect of Australia's system for the taxation of capital, an immediate reaction is to address the current high levels of company taxation by reducing the corporate tax rate. Whilst we recognise that any changes to the corporate tax rate will need to have regard to the short term cost to federal tax revenues, it is also important to assess the second order benefits to the Australian economy. Weighing up the efficacy of Australia's dividend imputation system with the costs and benefits of potentially adopting alternate systems for the taxation of companies will need to be considered in this context. The uniqueness of Australia's 'two-speed' economy will also need to be considered in formulating tax policy that is sustainable for the future. The two-speed economy arises because of the significant growth in the mining sector of Australia's economy in comparison to the non-mining sectors. The mining sector's performance has more recently been influenced by strong global demand for mineral and energy resources. This is despite upward pressure on financing costs as a result of recent financial market developments.[11]

Whilst the surge in benefits from the mining sector have been distributed elsewhere through mining company shareholdings and increased federal tax revenues[12], it is important not to lose sight of the benefits of diversifying and becoming less resources dependent by formulating policies around promoting and sustaining growth in other sectors in the event the resource boom declines.

Positioning Australia as a regional hub and regional pace-setter in, for example, the services industries should ensure Australia sustains higher standards of living in the long run.

In addition, lessons learnt from the recent global credit crisis may result in tax policy being designed to attract long term equity capital in favour of debt capital, to ensure companies are better immunised from the risk of bankruptcy.

The development of Australia's future tax system becomes a balancing act and presents an exciting and yet, challenging opportunity to undertake a comprehensive review of corporate taxation.

The following sections of this submission analyse the above themes and aim to:

- Further examine how Australia's taxation of capital income (in particular its corporate tax burden) compares with OECD countries and whether it is internationally competitive (Section 4).
- Discuss the significance of how corporate tax links to economic growth and the level of FDI (Section 5).
- Recognise that any proposed reduction in the corporate tax rate requires consideration of Australia's dividend imputation system (Section 6).
- Explore various taxation of capital income systems (particularly alternate corporate tax systems) proposed and adopted around the world to identify whether there are desirable features of various systems that would complement Australia's tax reform objectives (Section 7).

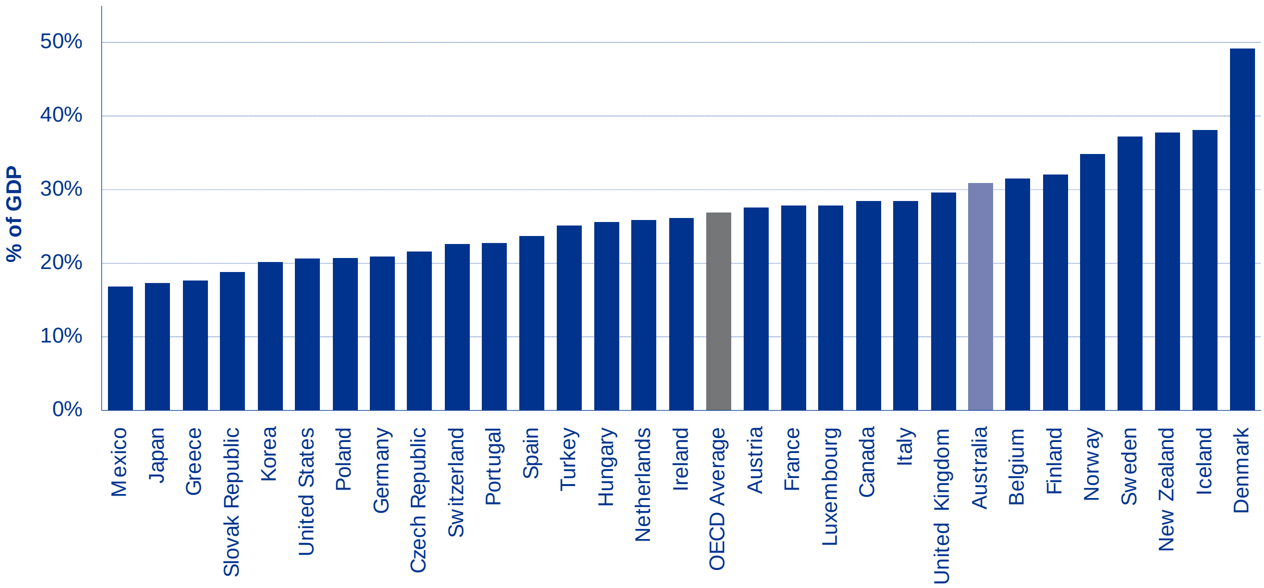
[11] Australian Government, *Mid-Year Economic and Fiscal Outlook 2007-08* (October 2007)
[12] Garton, P, Australian Treasury *Economic Roundup Issue 3, The resources boom and the two-speed economy* (2008)

4 International comparison – where Australia stands

One measure of Australia's relative tax burden, represented by total tax revenue as a percentage of GDP, puts Australia in 23rd place among the thirty member states of the OECD.[13] This measure of tax burden indicates that Australia could be classified as a 'low tax country'. However, this measure is debatable since it does not take account of different arrangements for social security/retirement incomes. Australia is unique in the OECD with its superannuation arrangements for retirement incomes that are correctly not included as part of the revenue base. Other OECD member states typically have social security levies through their tax systems imposed on employers, employees or both that are included as part of the revenue base.

Total tax revenue excluding social security provides a very different measure of Australia's total tax burden that calibrates it as the eighth highest in the OECD.

Figure 4-1 OECD Tax Revenue (excluding social security) as a percentage of GDP, 2005



Source: OECD Revenue Statistics 1965-2006

[13] Australian Treasury, *Architecture of Australia's tax and transfer system*, Chapter 5 p201 (August 2008)

4.1 Taxation of capital income

In analysing the components of Australia's total tax burden, what does become readily apparent is that Australia places greater reliance on the taxation of capital income than many other countries.

Taxes on capital income include company tax, personal taxation on investments and property taxes. Australia's tax policy settings for the taxation of capital income clearly have ramifications across a number of areas including:

- future retirement incomes
- consumption levels and
- the source and amount of finance available to companies and whether investments are made in Australia or overseas.

Furthermore, the rapid growth in cross border investments has also highlighted the importance of international competitiveness when considering how Australia taxes savings and investments.

Australia's overall reliance on taxation of capital income in comparison to OECD members is highlighted in *Chart 6.5: Estimated capital taxation revenue in 2005*, of the Architecture Paper[14].

The Architecture Paper revealed the relative weight given in Australia to the taxation of capital as a percentage of total revenue (as compared to taxes on labour and consumption) ranks the highest when compared to other OECD countries. This was noted as "a surprising result in a globalising world with increasingly mobile capital flows for a small open economy to have the highest weight given to the taxation of capital income."[15] As a share of GDP, Australia's total tax burden on capital is around 11 percent, which is the fourth highest in the OECD. The total tax burden on labour income is around 12 percent of GDP (fourth lowest in the OECD) and the total tax burden on consumption is around nine percent of GDP (also fourth lowest in the OECD).

The Architecture Paper also highlighted that the high relative weight given to the taxation of capital income results from, inter alia, relatively high contributions of company tax. Later in this section this issue is discussed in greater detail given the importance of the corporate sector to Australia's future economic prosperity.

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.

It is noted that Australia has one of the higher maximum personal tax rates on capital gains, when compared with OECD-10 members notwithstanding the 50 percent discount available for gains on assets held for at least 12 months. Australia also has a very high maximum personal rate of tax on interest income when compared with OECD-10 members (see *Chart 5.9: Comparative tax rates on capital income, OECD-10 (2007)*, of the Architecture Paper).[16]

The Architecture Paper further notes that:

- There is significant divergence within the OECD-10 countries on the treatment of capital gains. International regimes include no CGT at all, a flat or stepped rate of CGT as well as the use of a discount system like the one operating in Australia.
- Many of the OECD-10 countries have a lower tax rate on interest income compared to the personal tax rate on labour income. This generally arises because social security taxes levied by other OECD-10 counties are not applied to capital income. Half of the OECD-10 countries treat interest income as ordinary personal income similar to Australia. However, final withholding taxes on interest at source and the use of separate tax schedules with a lower tax rate on capital income are also used.
- By comparison, the use of a full dividend imputation system means Australia compares favourably with other OECD-10 countries in respect of the taxation of dividends from domestic sources, particularly for individuals who are average wage earners.

The accumulation and efficient allocation of capital is pivotal to the growth of every economy. As such, the taxation of capital income raises important issues concerning incentives to save, resource allocation and risk taking.[17]

The taxation of normal profits

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[14] Australian Treasury, *Architecture of Australia's tax and transfer system*, Chapter 6 p221 (August 2008)
[15] Australian Treasury, *Architecture of Australia's tax and transfer system*, Chapter 6 p220 (August 2008)
[16] Australian Treasury, *Architecture of Australia's tax and transfer system*, Chapter 5 p209 (August 2008)
[17] Warbuton, R and Hendy, P, *International Comparison of Australia's taxes* (2006)

Given the level and form of taxation of capital can affect the decision to invest and save, it is important to understand the different components of capital income.

The return on capital can be divided into the:

- inflationary component (which merely compensates the investor for the reduction in purchasing power arising from inflation)
- compensation for deferring consumption (combined with the inflationary component this represents the 'normal' return to capital)
- risk premium and
- 'supernormal' return (arising from access to a unique asset, etc).

The Architecture Paper notes that a nominal capital income tax base will include the above mentioned inflationary component. Even at a low rate of inflation there can be large differences in nominal and real (inflation-adjusted) EMTRs depending on whether the inflationary component is taxed. Australia has a comprehensive nominal income tax base, however, similar to other OECD countries, there are various concessions associated with particular types of returns to savings and investments. For example, as noted above, Australia's CGT system for individuals includes a CGT discount concession and Australia's dividend imputation system provides individuals with imputation credits in respect of underlying company tax paid.

In the Architecture Paper the comparisons of the nominal and real returns on superannuation, owner occupied homes, rental properties, listed shares and interest bearing accounts shows there are considerable differences between returns on different classes of assets. Moreover, these differences are further complicated when the tax regimes of different holding entities and different financing decisions are taken into account. The interactions with the transfer system (e.g. the means testing impacts on savings) adds a further element of complexity to investment decisions for individuals.

For example, as the entire nominal return for interest bearing deposits is taxed at an individual's marginal tax rate, the nominal EMTR on such deposits can be considerably higher than, for example, other savings options such as concessional (pre-tax) contributions to superannuation.

The above observations raise the question of whether other forms of savings, not just superannuation and the recently introduced first home owner savings accounts, should be encouraged through Australia's tax system.

The Architecture Paper notes that Australia borrows much more from overseas than it lends to overseas and as noted in the later section on superannuation contribution levels, Australia's net household savings have been negative for some time. Thus providing some form of incentive to save via interest bearing deposit accounts could increase the level of capital funds available in Australia.

The Architecture Paper does however contain a note of caution. If a tax saving concession merely results in a switching of savings from one vehicle to another; then there will be no overall increase in household savings. The Architecture Paper notes the international literature on the effectiveness of tax-preferred savings plans is somewhat mixed. Higher income households are said to be more likely to respond to saving concessions by switching their existing savings. It is considered that encouraging new savings depends on the level of take up by moderate-income households.

Accordingly, whilst the current Australian system of taxing interest bearing deposit accounts potentially warrants further consideration, any proposed concessions would need to be well targeted to achieve an increase in the level of net savings.

In summary, the observations in the Architecture Paper suggest that the AFTS Review should consider a number of issues surrounding the taxation of savings and investments in Australia. There are non-neutrality issues arising from the existing tax incentives provided to different forms of investments and this contributes to investment allocation inefficiencies and to complexities within the tax-transfer system.

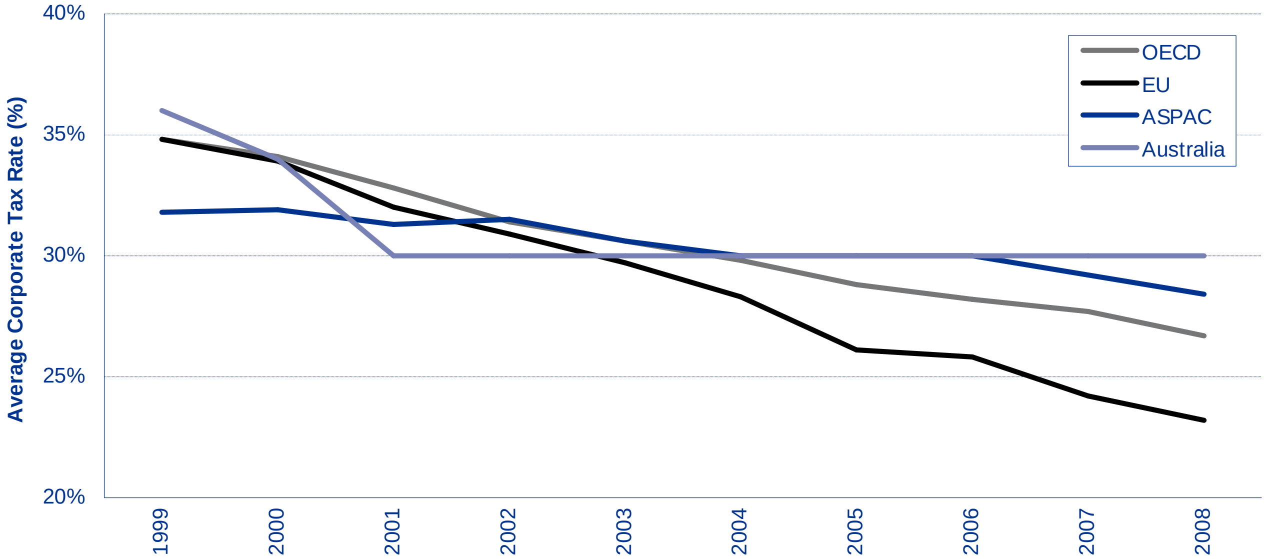
The globalisation of capital investment flows suggests that Australia needs to be more cognisant of its international competitiveness in the taxation of capital. Australia should be exploring whether international trends in the taxation of capital income provide valuable lessons in reshaping our taxation of capital regime for the challenges of the 21st century. In particular, questions arise as to whether Australia should be differentiating between the taxation of capital income and labour income.

We now discuss the taxation of companies as this forms a significant component of Australia's taxation of capital income collections. We explore the Australian corporate tax rate and the Australian corporate tax burden in an international context.

4.2 Trends in corporate tax rates

The global trend has consistently been for reductions in corporate tax rates. The trend towards lower corporate tax rates has been most pronounced in Europe, with many of the recent EU member states from Central and Eastern Europe reducing corporate tax rates as a key element of economic policy.

Figure 4-2 OECD, EU, ASPAC and Australia: Statutory average corporate tax rates



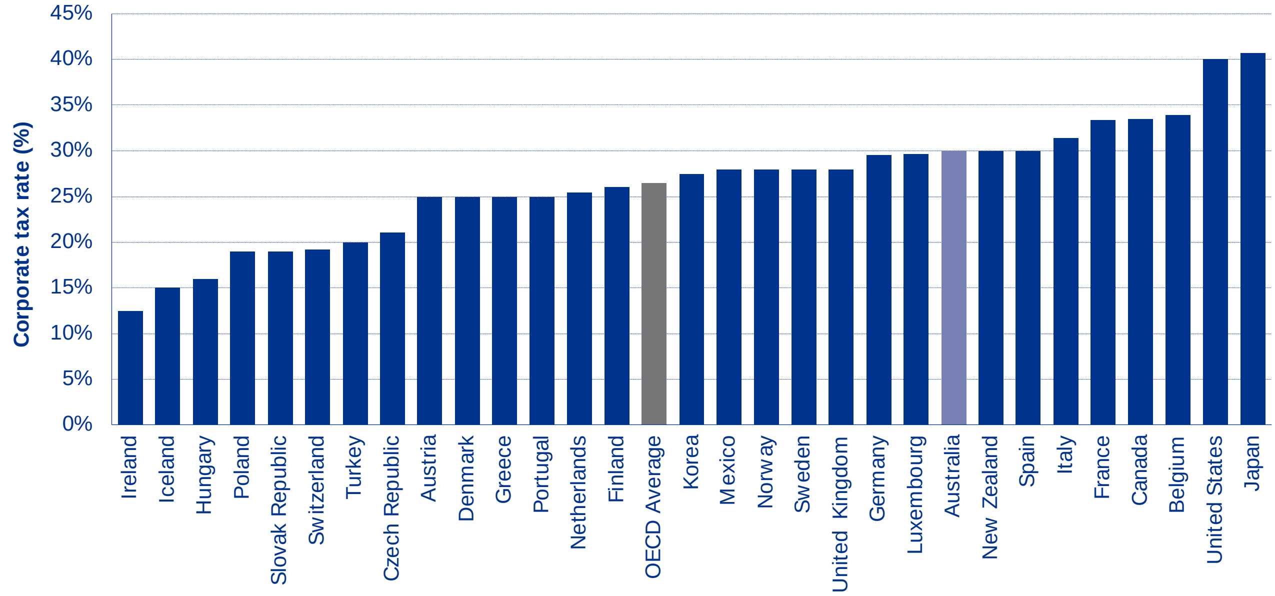
Source: KPMG's Corporate and Indirect Tax Rate Survey 2008

Australia reduced corporate tax rates from 36 percent to 33 percent in 2000 and then to 30 percent in 2001, in line with the recommendations of the RBT. These phased reductions put Australia's statutory corporate tax rate below the EU, OECD and ASPAC averages. These reductions in the corporate tax rate were accompanied by a broadening of the corporate tax base.

Since 2001, Australia's statutory corporate tax rate of 30 percent has become progressively less competitive with the EU, OECD and ASPAC averages, with many member states substantially reducing corporate tax rates. Based on the annual KPMG survey of global corporate tax rates of 106 countries surveyed, the global average (including the OECD, EU, ASPAC and Latin America) was 25.9 percent.[18]

[18] KPMG International, *KPMG's Corporate and Indirect Tax Rate Survey 2008* (September 2008)

Figure 4-3 OECD: Statutory corporate tax rates, 2008

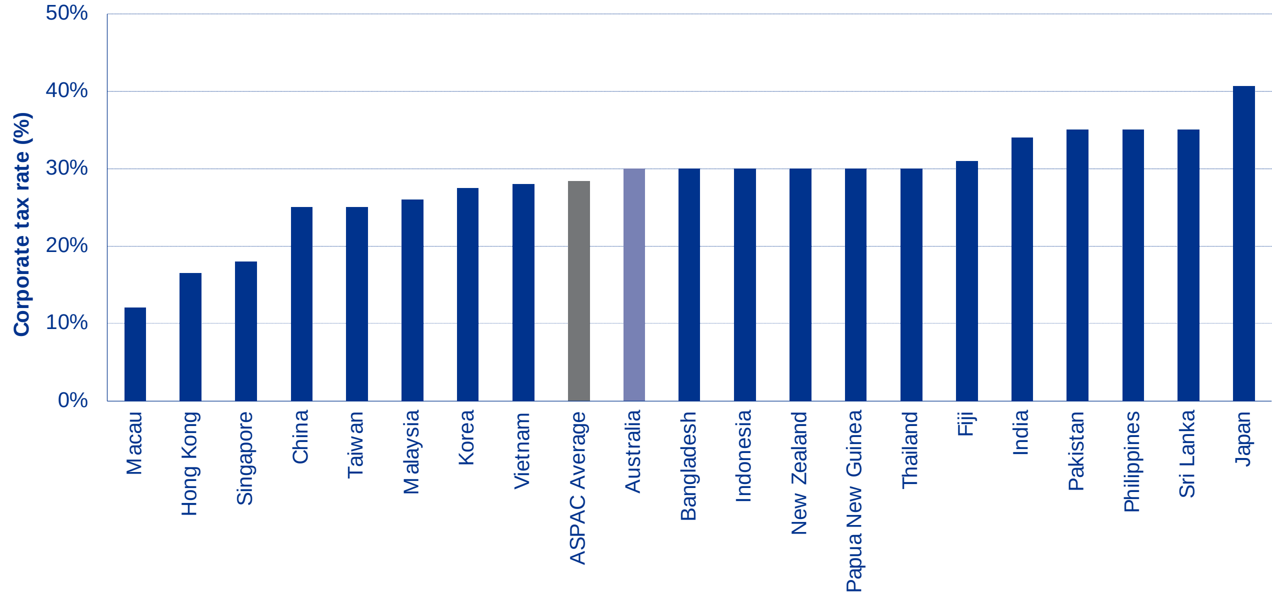


Source: KPMG's Corporate and Indirect Tax Rate Survey 2008

Note: Canada, Germany, Japan, Switzerland and United States headline rates combine national and average sub-national corporate tax rates.

Corporate tax rates in ASPAC are largely not reflected in the OECD data (New Zealand, Japan and Korea excepted) and reductions have generally been less pronounced than in Europe, but when statutory corporate tax rates have been revised, the trend has typically been downwards. As many economies in ASPAC are still developing and therefore at a different stage of economic development than Australia, they offer substantial tax concessions that are designed to attract FDI. These measures include free-trade zones, concessions for 'pioneer industries' and sector specific concessions for strategic industries. Thus, whilst many economies in ASPAC are not as readily comparable with Australia and the OECD member states, they are located in the same geographical region as Australia, competing for the regional capital flows. Hong Kong and Singapore in particular are significant competitors in sectors such as financial services and as a location for establishing regional headquarters. They also have low statutory corporate tax rates compared to Australia.

Figure 4-4 ASPAC: Statutory corporate tax rates, 2008



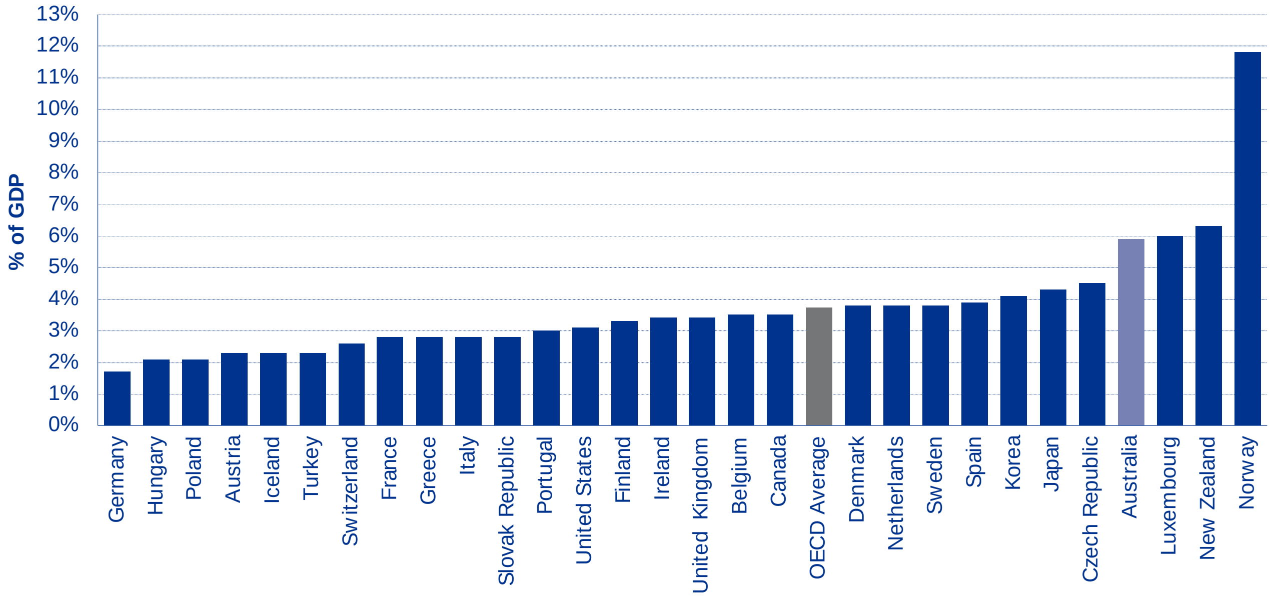
Source: KPMG's Corporate and Indirect Tax Rate Survey 2008

4.3 Corporate tax burdens

Australia's corporate tax burden, measuring corporate tax as a percentage of GDP, has been amongst the highest in the OECD for some years. The corporate tax burden, is in many respects, a more representative measure than the 'headline' statutory corporate tax rates, because it is neutral with respect to any concessions, incentives or structural issues inherent in different corporate tax regimes.

On the other hand, there are some common propositions put forward on the ratio of Australia's corporate tax to GDP seeking to dismiss its significance. These propositions are analysed in Section 4.3.3 to bring greater clarity to the debate of Australia's corporate tax burden.

Figure 4-5 OECD: Corporate tax as a percentage of GDP, 2005



Source: OECD Revenue Statistics 1965-2006

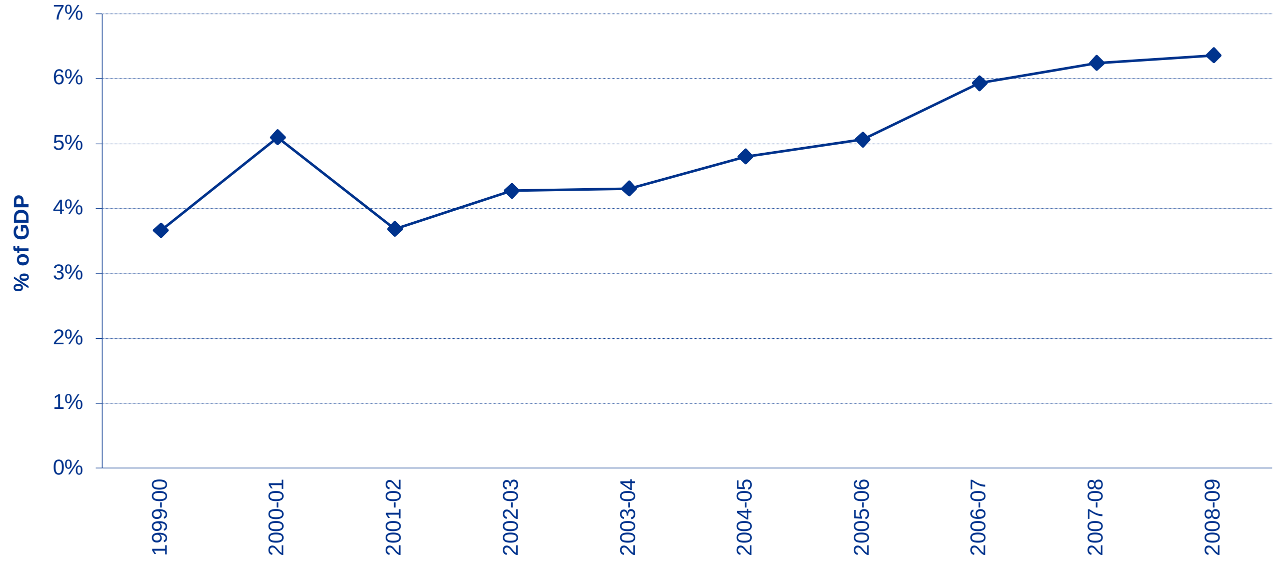
Note: Average does not include Mexico, as disaggregated data for corporate and individual income tax revenue is not available.

Comparison of relative corporate tax burdens places Australia at the higher end of the OECD, along with Luxembourg, New Zealand and Norway. Norway is the second largest non-OPEC oil producer and the revenue it collects from companies engaged in oil and gas activities increases its corporate tax burden.

4.3.1 Australia's increasing corporate tax burden

The Government budget data since 1999 demonstrates Australia's increasing corporate tax burden in the years following the RBT. A technical change caused some revenue to be brought forward in 2000-01, which explains the increase in that fiscal year.

Figure 4-6 Australia: Corporate income tax (excluding PRRT and superannuation) as a percentage of GDP

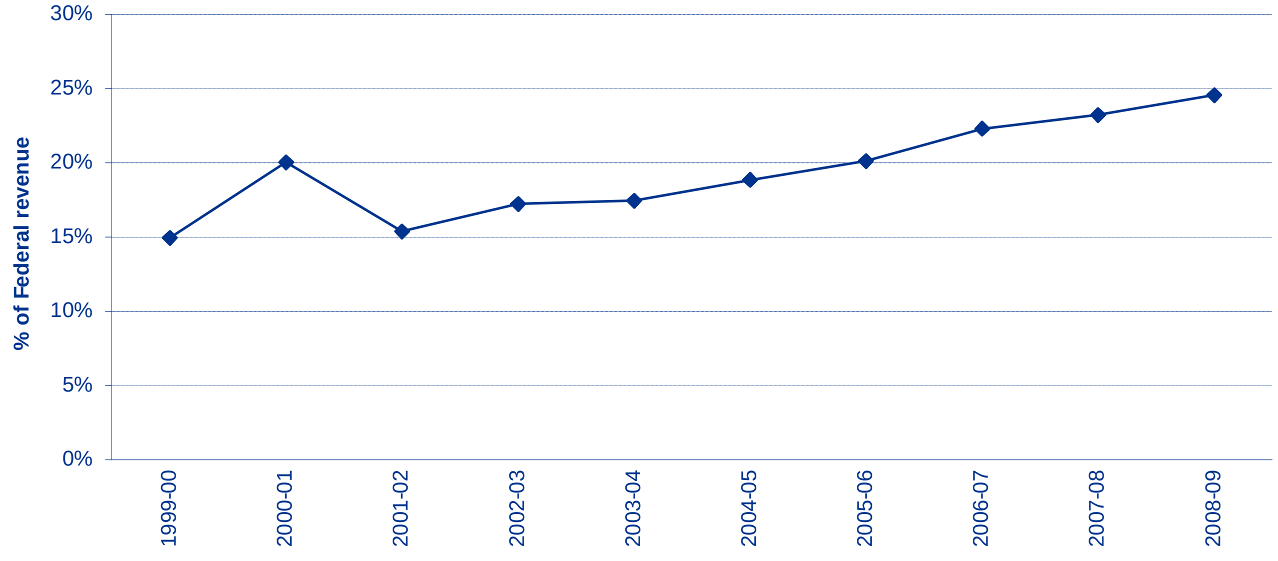


Source: Government Budget Papers 1999-2008

There are some minor differences between the Government budget measures of corporate tax as a percentage of GDP and the OECD measures that are likely to be referable to OECD data comparisons being based on calendar rather than fiscal years.

Reflecting the increased corporate tax burden as a percentage of GDP, corporate tax has been steadily increasing as a component of federal tax revenue (inclusive of GST).

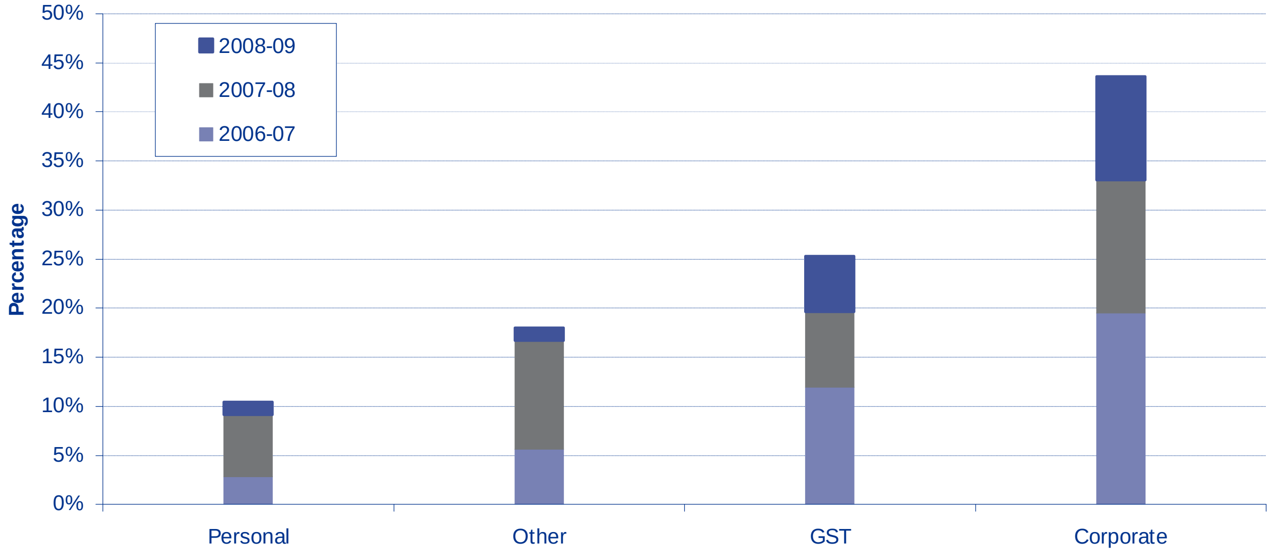
Figure 4-7 Australia: Corporate income tax (excluding PRRT and superannuation) as a percentage of federal revenue



Source: Government Budget Papers 1999-2008

Corporate tax receipts have consistently been the fastest rising component of federal tax revenue. The recent increases in corporate tax receipts might be explained in part by the level of economic activity, in particular from the resources sector, but much of this trend pre-dated the resources boom.

Figure 4-8 Australia: Growth of tax receipts



Source: Government Budget Papers 1999-2008

The fact remains that corporate tax receipts have been increasing significantly over the past decade, both as relative shares of the total economy and as the fastest growing component of federal tax revenue.

4.3.2 Australia's corporate tax burden post-RBT

In the years following the RBT, the Australian corporate tax base has become one of the broadest in the world. Some of the base broadening measures include:

- a uniform capital allowance regime that is close to effective life (in many other countries, capital write-offs for investment in plant and equipment are accelerated)
- no write-offs for goodwill acquisitions (tax deductible write-offs are available in countries such as the US and the UK)[19]
- the absence of a tax loss carry back regime
- relatively few tax shelters and concessions and
- specific and general integrity provisions that apply to a wide range of activities, including foreign source income, infrastructure investment and capital management transactions.

Since the Australian corporate tax base is relatively broad, Australia has the capacity to reduce its statutory corporate tax rate. A reduction in the rate of corporate tax could potentially lessen barriers to investment, assist Australia's productivity and longer-term prosperity.

4.3.3 Australia's high corporate tax burden: some propositions

There are a number of propositions that seek to explain Australia's high corporate tax burden which need consideration for there to be clarity in the debate. In our view, each of the following propositions makes some contribution to Australia's comparatively high tax burden but no individual proposition or the combination of propositions can be used to readily explain the significant difference in the Australian corporate taxation burden as compared with other OECD countries. In our opinion, Australia would seem to tax its companies at an internationally uncompetitive level. The discussion below seeks to further explore some of the propositions.[20]

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[19] Warbuton, R and Hendy, P, *International Comparison of Australia's taxes,* pp 174-175 (2006)
[20] Business Council of Australia, *Corporate taxation: an international comparison, 2006 Update*, pp 13-16 (December 2006)

Proposition 1: Australian companies' strong profit growth is the key driver in Australia's high corporate tax take

A proposition often advanced is that Australian companies have had strong profit growth over the past decade and this is what is driving the high tax burden in Australia compared with other countries.[21]

This proposition assumes that:

- Australian companies have been doing unusually well compared to all of their potential competitors and
- the taxation burden is aligned with company profit growth.

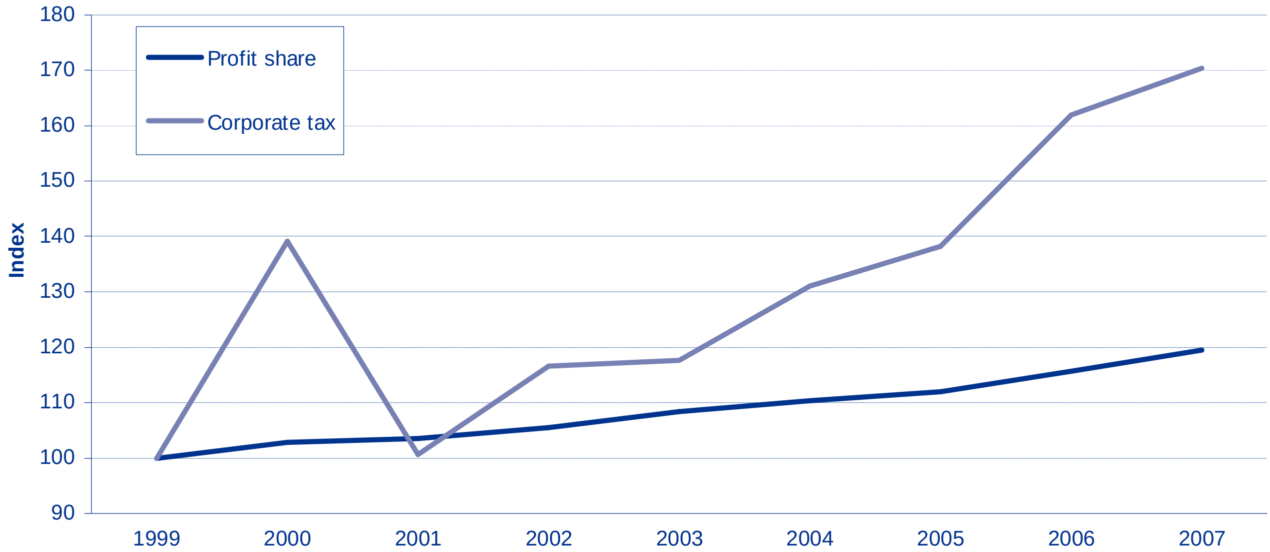
Figure 4-9 compares the growth in the Australian company profit share and the growth in corporate tax revenue. Whilst Australian companies are doing well, it is clear the increase in taxation burden is not correlated and is increasing at a rate which is significantly above the increase in the corporate profit growth.

Arguably this proposition is not supported by detailed analysis.

Davidson's (2008)[22] analysis also shows that in comparison to the ratio of weighted and unweighted corporate tax revenue to GDP, not only is Australian corporate tax revenue high by OECD standards but it has increased dramatically since 1985, even though the corporate tax rate has declined in the same period.

Thus, increases in corporate profits in Australia are not enough to explain the greater increase in corporate tax revenue and that, as Davidson (2008) has noted, "It is likely that the corporate tax is having a large negative impact on the economy".

Figure 4-9 Australia: Profits and corporate tax growth



Source: Profit Share (profits as a share of total factor income) – ABS and Corporate Tax – Australian Government Papers

Proposition 2: Australian companies no longer have losses

Another proposition sometimes advanced to explain Australia's high corporate tax burden is that Australian companies have been so profitable for so long that there are no longer any losses to carry forward against income. The ability to use deductions is a combination of both the pool of the deductions and capacity to use them. The most recent ATO taxation statistics[23] show tax losses deducted with a total value of over $11 billion in 2005-06 (see Figure 4-10).

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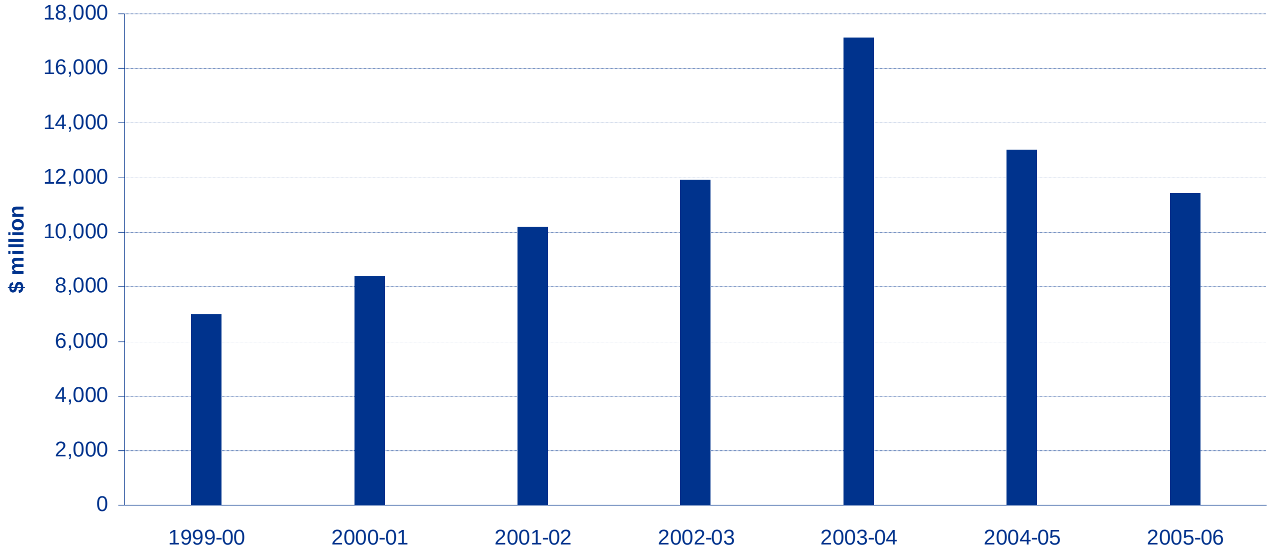
[21] Australian Treasury, *Architecture of Australia's tax and transfer system*, Chapter 5 p211 (August 2008)
[22] Davidson, S, *CIS Policy monograph 87, The Faulty Arguments Behind Australia's Corporate Tax*, The Centre for Independent Studies (2008)
[23] Australian Taxation Office, *Taxation Statistics 2005-06* (2008)

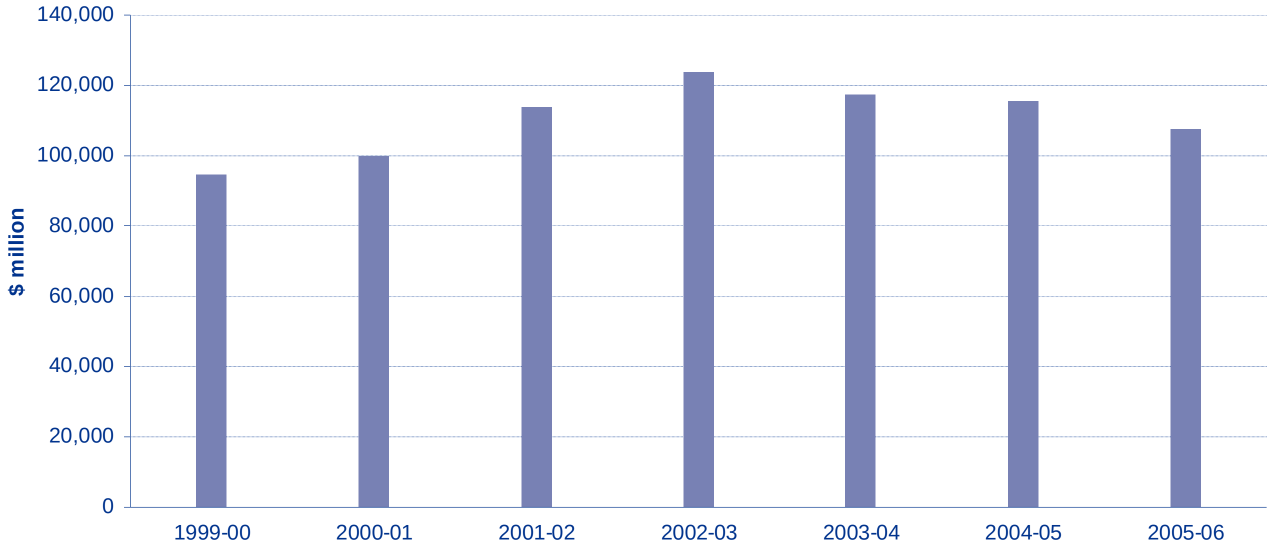
Figure 4-10 Tax losses deducted



Source: Australian Taxation Office, Taxation Statistics 2005-06, (2008)

Similarly, the company tax losses carried forward in 2005-06 had a total value of over $107 billion. It is clear from Figure 4-11 that there is no lack of available losses for use against gains. Thus, contrary to the proposition, it appears that losses are still being made and whilst their utilisation has declined in more recent years, the decline has not been substantial.

Figure 4-11 Tax losses carried forward



Source: Australian Taxation Office, Taxation Statistics 2005-06, (2008)

Proposition 3: Australia's dividend imputation system drives the corporate tax burden

A key change to corporate taxation in the 1980s, via RATS, was the introduction of dividend imputation. Imputation provides Australian resident shareholders with a tax credit for corporate tax paid. This system ended the double taxation of company profits, previously taxed at both the corporate level and then again when received as dividends by shareholders. The introduction of imputation, combined with a CGT also encouraged companies to declare and distribute dividends to shareholders rather than retaining the profits within the company. Dividend imputation provided an additional incentive for Australians to invest in shares as an asset class.

The impact of Australia's system of dividend imputation is sometimes used to explain the high corporate tax take.[24]

If Australian companies are facing comparable corporate tax rates in Australia and another jurisdiction and have a capacity to source their income, and therefore incur the tax liability in Australia, they may well choose to pay tax in Australia to generate franking credits for the payment of dividends to their Australian shareholders.

However, the franking credit incentive to pay tax in Australia rather than another country - where that choice is feasible - is unlikely to be relevant for choices between Australia and alternate countries where:

- the total effective tax burden is lower in the other jurisdiction
- companies are not resident in Australia or
- companies have significant foreign shareholders (New Zealand possibly excepted) that obtain no (or limited) benefit from Australian franked dividends.[25]

An alternative proposition is that as the corporate income tax in Australia is a prepayment of personal income tax[26,] and about 35 percent of the corporate tax revenue is provided back to shareholders in the form of credits, the corporate tax revenue ratio is overstated.[27] Whilst Australia's full imputation system may be said to inflate the corporate tax revenue to GDP ratio, other countries adopt alternate corporate systems that have a similar effect to Australia's imputation system.

Thus, unless the ratio of corporate tax revenue to GDP of other countries with alternate corporate tax systems can be further analysed, the effect of the imputation system to explain Australia's corporate tax burden would seem to be somewhat inconclusive.

Proposition 4: Differences in measurement account for Australia's significantly higher corporate tax burden

There are always differences in the measurement of the corporate tax burden across different economies. The proposition is that Australia's burden on companies is 'inflated' compared with other OECD countries by the inclusion of data which Australia may not necessarily agree to be part of the company tax base. The OECD comparison data appropriately includes taxes on superannuation fund income (including the superannuation surcharge) and the PRRT[28]. However, these latter taxes comprise only 14 percent of total corporate tax revenue and even if they were disregarded completely from the calculations, Australia would still have an estimated 2008-09 corporate tax burden of 6.4 percent, well above most comparative economies (see Table 4-1).[29]

[24] Australian Treasury, Architecture of Australia's tax and transfer system, Chapter 5 p211 (August 2008)
[25] It should be noted that imputation will be less relevant for non-resident shareholders as they are unable to utilise franking credits to offset any Australian tax liability. Instead, franked dividends are not subject to Australian withholding tax to the extent that they are franked. A non resident's preference between being subject to withholding tax or receiving a franked dividend would depend on the rules to prevent double taxation in their home tax jurisdiction.
[26] Davidson, S, *CIS Policy monograph 87, The Faulty Arguments Behind Australia's Corporate Tax*, The Centre for Independent Studies (2008)
[27] Davidson, S, *CIS Policy monograph 87, The Faulty Arguments Behind Australia's Corporate Tax*, The Centre for Independent Studies (2008)
[28] These types of taxes are normally included in the corporate tax burden of other jurisdictions. If they were disregarded for Australia they would also need to be disregarded for other jurisdictions. FBT, which is a tax paid by companies is not included in the Australian corporate tax burden calculations.
[29] Australian Treasury, *Pocket Brief to the Australian Tax System* (2008)

Table 4-1 Contributions to the total tax burden

Tax	2008-09 ($m)	%	GDP (%)
Corporate income tax	73,490	85	6.4
Superannuation funds	9,750	11	0.8
PRRT	2,920	3	0.3
Total	86,160	100	7.5

Note: The % column does not add to 100% due to rounding.
Source: Government Budget Paper No 1: Budget Strategy and Outlook 2008-09, Statement 5: Revenue, Table 6: Australian Government general government revenue (2008)
GDP data www.economagic.com

4.4 Conclusion

Based on the discussion and comparisons above, it would seem difficult to classify Australia as a 'low tax country'.

The Architecture Paper reports that Australia's relative tax burden, represented by total tax revenue as a percentage of GDP, puts Australia in 23rd place among the OECD-30. However, further analysis suggests that Australia's corporate tax burden, measured in terms of corporate tax as a percentage of GDP, has been amongst the highest in the OECD for some years.

Given the increasing global mobility of capital, Australia's current corporate tax burden does not appear to be internationally competitive and is potentially placing Australia at a disadvantage when trying to attract regional investment funds.

Whilst many of the economies in ASPAC may not be readily comparable with Australia and other OECD member states, Australia is competing for the same regional investment dollars in a number of corporate sectors that are established, or are being established, by countries in this region. Thus, in certain corporate sectors Australia is faced with strong regional competition from countries, such as Singapore and Hong Kong, that have corporate tax rates of 18 percent and 16.5 percent respectively.[30]

Accordingly, Australia's taxation of capital income regime and in particular Australia's corporate tax burden should be reviewed as a priority.

Recommendation Section 4: The AFTS Review should analyse Australia's taxation of capital income regime and assess whether Australia has the right incentives for individuals to provide for their future and to provide capital to businesses. In particular, the AFTS Review should address the current corporate tax burden as a tax policy review priority.

The increasing global mobility of capital has significant ramifications for Australia's taxation of capital income regime.

In a global economy, Australia's high corporate tax rate would seem to be internationally uncompetitive. Relying on the propositions outlined earlier to explain this tax burden could well be misleading and do not in themselves justify the retention of the current level of corporate taxation in Australia.

[30] KPMG International, *Corporate and Indirect Tax Rates Survey 2008* (September 2008)

5 The link between corporate tax and productivity

5.1 Corporate tax linked to economic growth

There have been numerous studies indicating that capital is far more responsive than labour supply to tax cuts. Economic theory suggests this is true for all economies over long periods of time, but it is particularly (and increasingly) true as capital becomes increasingly mobile in the global economy.[31]

Kingston (2006) cites two studies on the link between a cut in the corporate tax rate and economic growth. Kingston (2006) refers to a study performed by Lee and Gordon (2005)[32], that found a cut of 10 percent in the country's top corporate rate is associated with a 1.82 percent per year rise in the growth of GDP. By contrast, a cut in the top personal rate has no significant effect on GDP growth.

The other study referred to by Kingston (2006) was conducted by Hassett and Mathur (2006)[33] and found that a cut of 10 percent in a country's top corporate rate is associated with a near equal percentage rise in the domestic pre-tax wages in manufacturing and thus, Kingston argues that cutting personal taxes is not the only tax policy available for lifting take home pay.

Lee and Gordon (2005) study

Kingston (2006) acknowledged the findings of Lee and Gordon's (2005) study. Their study found, based on a sample of 67 countries over a period 1980 to 1997, a cut of 10 percent in the top corporate tax rate was associated with a 1.82 percent per year rise in the growth of GDP per head. Kingston (2006) noted that a sustained rise in growth of this magnitude would see GDP per head rise within a generation to a level 50 percent higher than it would have otherwise been. In contrast, a reduction in the top personal tax rate would have had an insignificant effect on GDP per head.

Hassett and Mathur (2006)

Hassett and Mathur (2006) examined the level of wages in manufacturing industries in 72 countries over the period 1981 to 2003. Their study found that a cut of 10 percent in the domestic corporate tax rate was associated with a near equal rise in the domestic wage rate but changes in personal taxes had no significant effect on wages.

Their study also found that with wages significantly responsive to corporate taxation, the responsiveness of wages to corporate taxation is stronger in smaller countries. Their logic was that a cut in the corporate tax rate had spill-over benefits to the labour market and served as an indirect means of achieving, in the longer term, increases in pre-tax wages. The likely mechanism to achieve this involves lowering corporate taxes to stimulate investment, which leads to a high capital-labour ratio. Wages tend to increase when capital becomes abundant.

[31] Kingston, G, 'Tax Reform: A Different View', Proceedings of the 35th Australian Conference of Economists, Curtin University of Technology, Perth (2006)
[32] Lee, Y and Gordon, R, 'Tax Structure and Economic Growth', *Journal of Public Economics, 89* pp 1027-1043 (2005)
[33] Hassett, K, and Mathur, A, *Taxes and Wages* (2006)

Hassett and Mathur (2006) also found that there appears to be a link between high tax ‘neighbours’ and high domestic wages. The suggestion is that as capital flows out of high tax ‘neighbour’ countries to low tax countries, this increases worker productivity and hence wages in the low tax country. Thus, countries try to compete for capital with other countries by lowering their relative tax rates.

Davidson (2008)

In addition, Davidson (2008)[34] refers to the work of Lee and Gordon (2005) whose findings (noted above) reveal the relationship between corporate taxation and economic growth. Davidson (2008) concludes “It is likely that the corporate tax is having a large negative impact on the [*Australian*] economy”, (our emphasis).

Djankov and co-authors (2008)

A recent study performed by Djankov et al (2008)[35] investigated the impact of effective corporate tax rates on aggregate investment, FDI and entrepreneurial activity over 85 economies including Australia. The study found corporate tax rates are negatively correlated with growth and for example, a 10 percent increase in the effective corporate tax rate reduces aggregate investment to GDP ratio by two percentage points. The study also concluded that high effective corporate income taxes are associated with greater reliance on debt, as opposed to equity finance and slower economic growth.

Ireland’s success

Both Kingston (2006) and Gruen (2006) refer to Ireland and attribute its economic success to its low corporate tax regime. In 1987, Ireland sought investment in specific sectors with a company tax rate for chosen investors of 10 percent. Ireland currently has a corporate income tax rate for active income of new operations of just 12.5 percent. Between 1996 and 2005 it attracted around five times more FDI capital than Australia.[36] It has been proposed that Ireland’s economic growth supports the empirical study by Lee and Gordon (2005) of the correlation between economic growth and the company tax rate.

5.2 Corporate tax linked to foreign direct investment

It is has been recognised that the potential benefits to Australia of greater FDI include greater labour income through increased productivity and employment if Australia’s capital stock increases, and positive externalities or spill-overs associated with FDI, which improve labour and capital productivity and hence labour and capital income. Spill-over benefits include Australians learning new business methods and skills, developing overseas contacts, benefiting from technology transfer, and increasing competition in domestic markets.[37]

It has been argued that attracting FDI is vital for economic growth and development strategies in Australia. Being a net capital importer, Australia seeks to attract and retain FDI because Australia’s national savings have not been sufficient to finance investment needs and Australia’s level of R&D has traditionally not been sufficient to meet the country’s technology needs.[38] In 2001, the ACCI undertook extensive research on the drivers of FDI and found in a sample of 45 countries that corporate taxation in addition to foreign investor control, cost of capital, regional integration, protectionism and shareholder rights and responsibilities, were all factors of greatest importance in raising levels of inward FDI.

In addition to the study by Djankov et al (2008), which found corporate taxation has a large adverse effect on FDI, De Mooij and Ederveen (2003)[39] performed an analysis of the relationship between foreign investment and corporate tax regimes and concluded that for each one percentage point reduction in the corporate tax rate, FDI will rise by around 3.3 percent.

[34] Davidson, S, *CIS Policy monograph 87, The Faulty Arguments Behind Australia’s Corporate Tax*, The Centre for Independent Studies (2008)
[35] Djankov, S, Ganser, T, McLiesh, C, Ramalho, R and Scleifer A, *The effect of corporate taxes on investment and entrepreneurship*, Third Draft (January 2008)
[36] Gruen, Dr N, *CEDA Information Paper 85,Tax Cuts to Compete - The influence of corporate taxation on Australia’s economic growth*, Committee for Economic Development of Australia (CEDA) (2006)
[37] Kelly, J and Graziani, R, *Economic Roundup Spring 2004, International trends in company tax rates – implications for Australia’s company income tax* (2004)
[38] Australian Chamber of Commerce and Industry, *Issues Paper, Attracting Foreign Direct Investment – APEC Could Lead* (May 2007)
[39] De Mooij, RA and Ederveen, S, ‘Taxation and Foreign Direct Investment: A Synthesis of Empirical Research’, *International Tax and Public Finance*, 10, 673-693 (2003)

The Architecture Paper noted that on average, the literature reviewed found that a one percentage point increase in the rate of corporate tax would result in a decrease in FDI of 3.72 percent. In addition, the responsiveness of FDI to tax has increased over time, with investments in physical capital more responsive than other investments (such as acquisitions).[40]

Recommendation Section 5: In analysing the corporate tax burden (see Recommendation Section 4) and considering the affordability of a corporate tax rate reduction, the modelling by the AFTS Review needs to weigh up the longer term productivity and investment benefits against any short term adverse impacts on Government revenue.

A number of studies indicate that capital is more responsive than labour supply to tax cuts with greater potential for GDP growth. The AFTS Review needs to consider and, where appropriate, utilise the findings of these studies in modelling the cost/benefit analysis of corporate tax reform and any other reforms to the taxation of capital income.

[40] Australian Treasury, *Architecture of Australia's tax and transfer system*, Chapter 8, p269 (August 2008)

6 An assessment of Australia's dividend imputation system

The preceding sections of this submission note the Australian corporate tax burden is uncompetitive in comparison to OECD member states and presents a number of regional challenges to Australia.

Whilst we have noted studies that have concluded that a reduction in the corporate tax rate has longer term benefits that should mitigate the short term revenue costs, we also acknowledge that there have been various options put forward to pay for such a reduction in company tax.

Some tax commentators submit the removal of the dividend imputation system could fund a significant reduction in the corporate tax rate in Australia relatively easily.[41]

It is therefore necessary to give consideration to the current dividend imputation system, which was originally proposed in 1975 in the Asprey Report. Tax policy reform has generally been shaped and influenced by the dynamics of Australia's social and economic environment at the time the reform was contemplated. It is important to understand why the dividend imputation system and alternate systems of company and personal tax integration were accepted or rejected in the past. Revisiting these reasons in this context is important to evaluate whether the imputation system continues to be appropriate or alternatively, should be modified, so that it is sustainable in an era of globalisation and increasing international capital mobility.

In this section, we review the historical background of the imputation system and consider some of its current challenges.

6.1 The evolution of Australia's imputation system

A full dividend imputation system has been present in Australia's tax system since 1987. The RATS Draft Whitepaper outlines the lack of equity and efficiency of a classical system of company tax. Interestingly, prior to the proposals in the RATS Draft Whitepaper advocating a full imputation system, in 1975 the Asprey Report recommended Australia adopt a partial imputation of company tax, with a company tax rate that is less than the maximum marginal rate of personal income tax. It would appear that at the time, this recommendation, was influenced by the tax systems adopted in Canada and the UK.

In 1999, the RBT recommended further modifications to the imputation system (since enacted) by allowing excess imputation credits to be refundable to certain Australian residents including individuals and complying superannuation

[41] See for example, *Review of the National Innovation System, Venturous Australia - building strength in innovation* p99, notes recent proposals for a revenue neutral reduction in the company tax rate funded by the abolition of dividend imputation. One study even suggested the abolition of dividend imputation would fund a reduction in company tax to 19 percent.

entities. A further proposal (since enacted) of the RBT was the introduction of the CGT discount for individuals, trusts and superannuation funds that is now part of the tax landscape for equity investments.

6.1.1 Shareholder and company taxation pre-Asprey Report[42]

Well before the introduction of Australia's full imputation system and even the classical system of corporate taxation prior to that, shareholder and corporate taxation was in the form of a 'dividend deduction' system at the federal level[43], that resembled a form of an integration system (some forms are discussed in more detail in Section 7).

Before 1915 the States relieved economic double taxation through a dividend exemption system. However, the onset of World War I saw the introduction of the federal tax system. At the federal level, a dividend deduction system operated whereby a deduction was limited to assessable income (excluding capital and foreign source income). When distributing income to non-residents a company was required to either pay income tax on the distribution or at its discretion, withhold tax from the distribution. A shareholder of a company that chose the former option included the dividend in assessable income but, in determining the tax payable, deducted the tax paid by the company. The end result was that equivalent treatment was given to both resident and non-resident shareholders in relation to distributions.

Under the law at the time, income retained its character as it passed through intermediate entities. Hence, the relevant portion of income referrable to foreign source income, remained foreign source income not taxable to a resident company in Australia.

The Warren Kerr Commission in 1921-22[44] recommended the retention of the dividend deduction system at the federal level. It also recommended either tax previously paid be refunded to the company or that a gross-up and fully refundable credit mechanism operate at the shareholder level. The focus of the Warren Kerr Commission included considerations of vertical equity, ease of administration and revenue yield, but not international considerations. Despite the Warren Kerr Commission's recommendations, the Government abandoned the dividend deduction system for an imputation system in 1923.

The introduction of the imputation system in 1923 featured a corporate tax rate of five percent. From 1923, rebates of the five percent corporate tax were given to shareholders whose income (including the dividend but not the rebate) was taxable at a rate greater than five percent. Further in 1928 the rebate was extended to low marginal rate shareholders. However, due to the limitations of the rebate and the failure to gross up the dividend, the total corporate and shareholder taxes on distributed income did not represent taxation at the shareholder's marginal rate.

The imputation system had evolved by the time of the Ferguson Commission in 1934-1936 such that to calculate the rebate involved itemising the source of the dividend into eight separate categories.

The Ferguson Commission was primarily concerned with simplifying the system of corporate and shareholder taxation. The Ferguson Commission recommended converting the Australian tax system from a dividend imputation system to a shareholder relief system. Shareholders received a credit, independent of whether tax was paid at the company level or not. While the Government implemented most of the Ferguson Commission's recommendations, it did not implement the proposal that foreign sourced income be taxed with double taxation relief provided through a foreign tax credit system. So the exemption for foreign source income remained in place such that dividends paid from taxed foreign sources were exempt for an Australian resident shareholder.

Following efforts to raise additional revenue due to World War II, 1941 saw the introduction of what was known as the classical system of corporate taxation whereby a company was deemed to have a separate identity from its shareholders. This style of tax system remained in place for over 40 years. Initially, a number of the 'pass through' features of the imputation system were retained, such that all intercorporate dividends received by resident companies were still entitled to a full rebate and dividends funded from a foreign source income or a capital source were exempt in the shareholder's hands. The exemption for dividends funded from foreign source income was abolished in 1941 and a foreign tax credit was introduced in 1947. Australia started developing its treaty network from 1941 and withholding tax was introduced for dividends in 1959.

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[42] Taylor, J, 'Development of and Prospects for Corporate-Shareholder Taxation in Australia', *Bulletin for International Fiscal Documentation 57* (August/September 2003)

[43] A dividend deduction system was used from 1915 to 1923 at the federal level. From 1915 until the implementation of the Uniform Tax Scheme in 1942, the federal and state governments levied concurrent income taxes, with federal income tax introduced in 1915 which was a wholly territorial system. In this period, all the Australian States except Western Australia (which employed a form of imputation system) used some variant on a dividend exemption system. See Taylor, J, 'Development of and Prospects for Corporate-Shareholder Taxation in Australia', *Bulletin for International Fiscal Documentation 57* (August/September 2003)

[44] Taylor, J, 'Development of and Prospects for Corporate-Shareholder Taxation in Australia', *Bulletin for International Fiscal Documentation 57* (August/September 2003)

6.1.2 Asprey Report in 1975

In an environment where the corporate tax rate was 47.5 percent and the top marginal rate of personal income tax was 66.7 percent[45], the Asprey Report concluded it was clear that the classical system of taxation was in need of reform. The classical system taxed companies and shareholders separately and the separate system was criticised for 'double taxation' since shareholders were required to pay personal income tax on company profits that had already borne company tax.

The Asprey Report also highlighted what was important was the total amount of levy a particular kind of income bears, not the number of taxes by which that amount is collected.[46] This observation is interesting as there have been some recent examples of jurisdictions that have moved away from the imputation system and reverted back to a classical system coupled with a significantly lowered corporate tax rate. For example, the imputation system of taxation in Ireland, in existence since 1976, was abolished. A withholding tax regime on company dividends and other distributions with extensive exemptions under Irish domestic law, particularly for non-residents, together with a planned reduction in the standard corporation tax rate was introduced.[47] Thus, Ireland is often cited as a jurisdiction prepared to reconsider having a classical system of corporate taxation, but in return for a significantly lower corporate tax rate.

6.1.3 Problems with a classical system of company tax

The Asprey Report noted there are a number of disadvantages of a classical system, which appeared to have been exacerbated in an environment where high tax rates at both the company and the shareholder level were the norm at the time. The Asprey Report included the following observations:

- A classical system is inequitable. In low-income ranges, it discriminates against those who invest relatively more of their savings in equity. In very high-income ranges, it discriminates the other way. This would seem to defeat the general progressivity of the income tax.[48]
- The over taxation of the profit entitlements of some shareholders creates a bias against doing business in a corporate form, although the under-taxation of other shareholders has the opposite effect. The Asprey Report noted that tax law should, as far as possible, be neutral in its effect on the choice of a form of business organisation.[49]
- The separate system is not neutral as between equity and debt financing. Company income going in payment of interest on debt is not taxed at the company level, but only under the personal income tax in the hands of the lender. A bias is created in favour of investment in debentures and other fixed interest securities for all low income shareholders and a bias in favour of equity investment in high retention companies for high income shareholders. It creates pressure to increase the gearing of debt to equity and fixed-interest capital raising may become more difficult for less well established ventures with few assets that can be offered as security. The diversion of savings particularly of low income individuals away from equity investment, creates a gap in the flow of Australian funds to developmental enterprises requiring equity capital. It was also argued that the gap may then be filled to a greater extent by overseas investors than is felt desirable on general grounds.[50]

6.1.4 Options considered and rejected in the Asprey Report

The Asprey Report considered four alternative systems to mitigate the 'double taxation' issues caused by a classical system of company taxation:

- tax the allocation of profits
- tax actual distributions and accruals in the value of shares
- require distributions of all profits and tax these distributions and
- tax the company and exempt dividends from personal income tax.

The first three proposals were rejected generally on the grounds of the difficulties relating to the taxation of non-residents. The fourth proposal was rejected on equity grounds.

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45 Commonwealth Taxation Review Committee, *Commonwealth Taxation Review Committee Full Report 31 January 1975* (Asprey Report), Chapter 16, p224, Table 16.B (1975)

46 Commonwealth Taxation Review Committee, *Commonwealth Taxation Review Committee Full Report 31 January 1975* (Asprey Report), para 16.16 (1975). This was reaffirmed in the *Reform of the Australian tax system: draft white paper*, para 17.4 (1985)

47 Maher, *Cahiers de Droit Fiscal International*, *Trends in Company/Shareholder Taxation: Single or Double Taxation?*, *88a* (2003)

48 Commonwealth Taxation Review Committee, *Commonwealth Taxation Review Committee Full Report 31 January 1975* (Asprey Report), para 16.19 (1975)

49 Commonwealth Taxation Review Committee, *Commonwealth Taxation Review Committee Full Report 31 January 1975* (Asprey Report), para 16.20 (1975)

50 Commonwealth Taxation Review Committee, *Commonwealth Taxation Review Committee Full Report 31 January 1975* (Asprey Report), para 16.20 (1975)

Tax the allocation of profits[51]

Taxing the allocation of profits, a form of 'integration system' (discussed in Section 7) would require a company to allocate its annual profits to shareholders in accordance with their interests in those profits and require shareholders to include the allocations in their taxable income i.e. the company receives partnership treatment for tax purposes. The Asprey Report recognised this is a 'theoretical ideal' in avoiding double taxation given there would be no separate company liability for tax. This system was considered to be equitable and neutral, with liquidity problems for shareholders overcome if the company could make cash distributions sufficient to cover personal tax at the maximum marginal rate on the allocation.

This system was rejected in the Asprey Report on the basis of the practical difficulties that would arise, including:

- Where there are different classes of shareholders that have different rights to profits, the task of allocation will be problematic.
- The task of allocation will be greater when allocation must be made through a series of company shareholders.
- The taxation of non-resident shareholders under this system raises practical difficulties. The imposition of company tax under this system effectively acts as a withholding tax for foreign residents at a flat rate of tax. DTAs impose a limit on the tax imposed on a foreign resident and agreements would need to be renegotiated but securing a change in the provisions of the treaty would not be guaranteed.

Whilst the Asprey Report notes an arrangement of this kind could not be universally applied, it is interesting to note that the Asprey Report did not rule out this option for simple structures where interests of individuals in the company profits can be readily identified.

Tax actual distributions and accruals in the value of shares

Under this proposal, actual distributions and increases in the share values, reflecting profits not distributed, would need to be taken into account in determining the amount subject to tax. The proposed system would tax undistributed profits in so far as such profits are reflected in the value of shares. It would also tax other realised or unrealised gains in the company, as well as interest rate and other market factors, to the extent these are reflected in the value of the shares.

The Asprey Report ruled this option out on the basis

- It was not feasible to tax capital gains from all varieties of assets on an accruals basis and hence, it would not be neutral between shares and other assets.
- Annual valuation of shares would also be difficult.
- In relation to foreign residents, the practical difficulties noted above would also be equally applicable.

Require distributions of all profits and tax these distributions

By imposing an undistributed profits tax, this system would require distributions. The Asprey Report noted this approach achieves equity and neutrality between the retention and distribution of profits. However, it also noted that the system gives rise to similar concerns in relation to the taxation of foreign residents discussed above.[52]

Tax the company and exempt dividends from personal income tax

Although the option of exempting dividends from personal income tax was rejected on equity grounds, the Asprey Report did not discuss this option in significant detail. The Asprey Report was concerned with high-income shareholders diverting income to companies as a tax shelter and hence, the Asprey Report speculated that the company tax rate would need to be at the maximum marginal rate of personal tax, which for low income shareholders would be inequitable. The Asprey Report noted that personal maximum marginal rates would need to be reduced to mitigate the tax shelter problem. It also observed that a high marginal tax rate would deter foreign portfolio investors from making investments in Australian companies and direct investors would seek, by various devices or excess reliance on loan capital, to ensure that a controlled Australian company had little or no profits.

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[51] Commonwealth Taxation Review Committee, *Commonwealth Taxation Review Committee Full Report 31 January 1975* (Asprey Report), para 16.22-16.26 (1975)

[52] Commonwealth Taxation Review Committee, *Commonwealth Taxation Review Committee Full Report 31 January 1975* (Asprey Report), para 16.29 (1975)

6.1.5 Split rate system versus an imputation system[53]

In weighing up the need to mitigate 'double taxation' at the company and the shareholder level, as well as integrity concerns relating to the taxation of foreign residents and high-income shareholders, the Asprey Report indicated that consideration must be given to a system that makes some allowance at either the company or the shareholder level for company tax on distributed profits. The Asprey Report therefore considered the option of adopting a 'split-rate' system or an 'imputation system'.

A split rate system provides an allowance at the company level. For example, effectively two rates of tax arise if a deduction is allowed in computing profits. That is, undistributed profits are effectively taxed at a higher rate than distributed profits. The Asprey Report's observation on this system that was subsequently confirmed in the RATS Draft Whitepaper, suggested that a split rate system would provide foreign resident shareholders an advantage, particularly foreign investors that are residents of countries with which Australia has a DTA.

On the other hand, an imputation system, that provides relief at the shareholder level, permits a credit against personal income tax on dividends received to allow for all or some of the tax paid by the company on the profits distributed. It does not give rise to the differential tax rate issue noted above for a split rate system.

The Asprey Report considered the differences between the split rate and imputation systems were not significant at the domestic level and that if a withholding tax on dividends paid to residents is added to a split rate system, it will be 'virtually indistinguishable' in its consequence from a corresponding imputation system. However, the Asprey Report tended to favour some form of imputation system, although it did note the full imputation system is not wholly neutral between retention and distribution.[54]

The Asprey Report recommended (although not accepted by the Government at the time) that partial imputation be adopted as an immediate step (i.e. a partial credit for underlying company tax). Moreover, it was recommended in the interests of low-income shareholders, additional provisions be introduced by which a refund of tax may be made. Adopting a full imputation system would be gradual, preferably after adopting a partial imputation system, as it was argued there was a 'distinct danger' that much of the benefit of imputation would be capitalised immediately into the value of shares.[55]

In summary, a review of the evolution of Australia's imputation system, particularly the analysis undertaken as part of the Asprey Report, does highlight that a number of deficiencies had already been identified in seeking to operate a classical system of dividend taxation. In addition, Australia had considered a number of alternate company tax systems as part of the Asprey Report and ultimately recommended a form of dividend imputation.

6.1.6 Impact of an imputation system on foreign investors and on Australian outbound investment

The Asprey Report considered whether it was appropriate for the imputation system to provide a credit for underlying corporate tax paid to foreign resident investors or whether it was appropriate to provide Australian resident investors an imputation credit for foreign dividends paid.

At the time, it was considered that Australia was not under any obligation to extend imputation to foreign residents. However, the Asprey Report left open the possibility of revisiting this proposal in the future, noting that whether or not imputation is extended to residents of any foreign country will depend on the economic policies Australia may wish to pursue as well as on revenue considerations.[56]

In the interest of encouraging Australian investment abroad, the Asprey Report appeared to be amenable to allowing an imputation credit for dividends paid from foreign source profits that had not borne Australian tax but the system would need to confine the credit only to dividends paid from a foreign source i.e. it would not be creditable against other tax liabilities of the shareholder or refundable. However, the Asprey Report noted there would be considerable administrative complications, for example, the need for companies to distinguish between profits that have borne Australian tax and those that have not, with a credit treatment applying to dividends in the latter category.[57]

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[53] Commonwealth Taxation Review Committee, *Commonwealth Taxation Review Committee Full Report 31 January 1975* (Asprey Report), para 16.32 (1975)

[54] Commonwealth Taxation Review Committee, *Commonwealth Taxation Review Committee Full Report 31 January 1975* (Asprey Report), para 16.37 (1975)

[55] Commonwealth Taxation Review Committee, *Commonwealth Taxation Review Committee Full Report 31 January 1975* (Asprey Report), para 16.50-16.51 (1975)

[56] Commonwealth Taxation Review Committee, *Commonwealth Taxation Review Committee Full Report 31 January 1975* (Asprey Report), para 16.71 (1975)

[57] Commonwealth Taxation Review Committee, *Commonwealth Taxation Review Committee Full Report 31 January 1975* (Asprey Report), para 16.74 (1975)

6.1.7 RATS Draft Whitepaper in 1985

A dividend imputation system was contemplated again in the RATS Draft Whitepaper released in June 1985, prior to introduction of legislation containing the imputation system in 1987.[58] After considering the systems contemplated in the Asprey Report, the RATS Draft Whitepaper recommended a full or partial imputation system allowing credits received by resident individual shareholders on a broadly revenue-neutral basis. The condition of revenue neutrality would require the rate of company tax to be increased.[59]

The RATS Draft Whitepaper set out the advantages of the imputation system, which were largely driven by revenue neutral considerations[60].

The imputation system was intended to address the equity and efficiency problems that relate to a classical system i.e. double taxation of dividends because company income was taxed at a rate of 46 percent, whether distributed or not, and the individual shareholders also pay personal income tax on their dividends at their own marginal tax rates.

Being a major net capital importing country at the time, an advantage of an imputation system was that, as in some countries with imputation systems, imputation credits on dividends paid to foreign residents could be denied thus mitigating the revenue impacts to Australia.

Another stated advantage of an imputation system is that tax relief provided to shareholders can have regard to the cost of revenue by choosing the particular percentage (up to 100 percent in the case of full imputation) of company tax deemed to be prepayment of personal tax.

Difficulties associated with taxing the profits of local subsidiaries of foreign parents were regarded as the decisive factor against a split rate system (refer to earlier discussions on the split rate system). It was considered that the higher tax rate of undistributed profits of the subsidiary could be avoided by distributing them and having the parent reinvest the proceeds so the lower rate was applied despite the effect being that the subsidiary still had the funds.

Reiterating the administrative concerns initially highlighted in the Asprey Report, the RATS Draft Whitepaper ruled out a full integration system, adding the difficulties with such a system would be as follows:

- Shareholders could not complete their tax returns until the company's return was ready and provided a basis for allocating shares of undistributed profits and tax to each shareholder.
- If the company's final assessment differed from its initial return, either there would have to be an amendment of large numbers of personal assessments of shareholders or the amount of the amendment would have to be added (or deducted from) the tax allocated in the following year.
- The problem with administering taxation of foreign resident shareholders was also considered a major problem.

Thus, it was decided that full integration was not feasible at the time.

With the benefit of hindsight, the introduction of the imputation system has also been viewed as a form of integrity measure. One of the propositions that was discussed earlier in the context of analysing Australia's corporate tax burden was that an imputation system creates an incentive to pay company tax. That is, the ability of Australian shareholders to earn franked dividends provides a company with a strong incentive to maximise its taxable profits in Australia.[61]

6.1.8 RBT in 1999

Prior to the RBT and consistent with the recommendations in the Asprey Report, excess imputation rebates (credits) were not refundable and could not be carried forward, but they could be offset against other current year tax liabilities. The rationale prior to the RBT was that the system favoured by the Asprey Report was more limiting as to the availability of imputation credits. However, the non-refundability of excess credits potentially increased the incentives for streaming franked dividends away from lower marginal rate resident shareholders.[62]

Australia's current imputation system is largely the end product of recommendations made by the RBT in 1999. Prior to the RBT, the Government, in ANTS, had proposed that excess imputation credits be refunded to resident individuals and resident complying superannuation funds. The RBT supported this proposal, as it was seen to support the progressiveness of the tax system by ensuring that taxpayers were taxed at their appropriate marginal rates on

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[58] *Taxation Laws Amendment (Company Distributions) Act 1987* (Royal Assent 5 June 1987)
[59] Australian Treasury, *Reform of the Australian tax system: draft white paper*, para 17.33 (1985)
[60] Australian Treasury, *Reform of the Australian tax system: draft white paper*, para 17.2, 17.3, 17.23, 17.25 (1985)
[61] Uren, D, 'Globalisation has created company tax problems' in *The Australian* (11 August 2008)
[62] Taylor, J, 'Development of and Prospects for Corporate-Shareholder Taxation in Australia', *Bulletin for International Fiscal Documentation 57* (August/September 2003)

distributions. From 1 July 2000, excess imputation credits have been refunded to resident individuals, complying superannuation funds and certain tax-exempt institutions.[63]

In conclusion, following the analysis of corporate tax systems undertaken in the Asprey Report and its initial recommendations to adopt partial imputation, subsequent Governments have in fact embraced imputation even further to the extent that we now have refundable imputation credits. A move away from such a system would need to carefully weigh up whether the long established benefits of imputation are no longer sustainable in the 21st century.

6.2 Case study – Singapore

Given that Singapore is a significant regional competitor of Australia for capital and has recently abolished its imputation system it is worthwhile exploring Singapore's reasons for the decision.

Singapore moved from a full imputation system to an exemption or 'one-tier' system on 1 January 2003. The two systems co-existed during a five-year transitional period from 1 January 2003 to 31 December 2007. The transitional period provided companies with an opportunity to distribute any surplus franking credits in their franking account and minimised the impact of the shift in systems on shareholders. Since 1 January 2008, all dividends paid by resident Singaporean companies are subject to the one-tier system.

6.2.1 Singapore's imputation system

The Singaporean imputation system was similar to Australia's imputation system in providing that distributed profits of a company are effectively taxed at the shareholder's marginal tax rates with the corporate tax paid on the company profits treated as a prepayment of individual income tax. Further, companies were able to distribute 'exempt dividends' where they did not pay tax due to the availability of a tax incentive under the *Income Tax Act* or the *Economic Expansion Incentives (Relief from Income Tax) Act*. This ensured that the benefit of any tax incentives enjoyed at the corporate level were preserved when the profits were distributed to shareholders.

6.2.2 The one-tier system

Under the one-tier system, dividends are exempt from tax in the shareholder's hands and distributed corporate profits are only subject to tax once, at the corporate level.

Why the shift?

Singapore shifted from an imputation system to a one-tier system for the following reasons which were considered severe drawbacks of the then imputation system:[64]

- Imputation creates a disincentive for companies to distribute profits where they do not have sufficient imputation credits to attach to dividends. This was seen as discouraging holding companies from using Singapore as a hub for regional activities.
- Imputation is not adaptable to sophisticated business transactions and increases compliance costs (i.e. anti-avoidance measures were necessary to deal with complex business transactions thereby further increasing compliance costs).
- Imputation complicates the development of new tax policy as the impact of tax measures, particularly any relief measures, must be designed to operate in conjunction with imputation. The value of group relief was also considered to be undermined by imputation, because corporate groups that do not pay tax due to the existence of group losses did not generate imputation credits for distribution to shareholders.

In addition to addressing the above drawbacks with the imputation system, Singapore's Economic Review Committee observed the following advantages of the one-tier system:

- It provides for a simpler tax code which would reduce tax compliance and administration costs for businesses. This was seen as necessary to increase the competitiveness of Singapore's tax system against Hong Kong and Ireland which complement their low corporate tax rates with a one-tier system.
- The one-tier system would free companies from a number of restrictions relating to the distribution of corporate profit as dividends and could potentially result in higher dividend payouts for all shareholders.

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[63] ITAA 1997, Division 67, inserted by Act No.79 of 2000. Also see Taylor, J, 'Development of and Prospects for Corporate-Shareholder Taxation in Australia', *Bulletin for International Fiscal Documentation 57* (August/September 2003)
[64] Economic Review Committee: Sub-committee on Policies Related to Taxation, The CPF System, Wages & Land, *Restructuring the Tax System for Growth and Job Creation,* pp32-33 (2002)

6.2.3 Assessing the impact of the one-tier system

Under the imputation system, individuals on low marginal tax rates would be entitled to a refund of excess tax credits. However, under a one tier dividend exemption system, the main disadvantage was that individuals on low marginal tax rates would bear a heavier tax burden in respect of their dividend income. Notwithstanding this, it was not considered to be a significant problem because the shift to a one-tier system was accompanied by a proposal to also exempt interest income from taxation and it was considered that low-income earners generally invest in bank deposits rather than equities. Therefore, any increase in tax burden on dividend income would be offset by the decrease in tax on interest income. [65]

The second impact of the one-tier system was that any expenses incurred in earning dividend income would not be deductible, as the income is exempt from tax whereas such expenses would be deductible under an imputation system and may have given rise to a tax refund for shareholders. There is no quantification of the impact of this change in Singapore.

There is some uncertainty as to how the one-tier system would impact upon non-resident shareholders. Under imputation, the non-resident would most likely have been taken to have paid tax in Singapore on the dividend income and received a credit for the tax paid, depending on their domestic tax regime and any applicable tax treaties. The Singapore revenue authority accepts that under the one-tier system, no tax is taken to have been paid in Singapore on dividend income and tax treaties, which are prima facie about the avoidance of double taxation, would not provide relief to the shareholder from domestic taxes on dividend income from Singapore resident companies. It is expected that the taxation of dividend income for non-residents of treaty countries may be resolved through discussions between competent authorities in the short term and may result in changes to Singapore's tax treaties in the longer term.[66]

It is important to note that, the top marginal tax rate in Singapore was aligned to the corporate tax rate of 20 percent in 2007. Prior to that, the top marginal tax rate was only 22 percent. Therefore, the revenue impact of the shift in systems is minimised, as once the corporate tax rate and the top marginal tax rate are harmonised, imputation would not result in any additional tax payable by shareholders and would only result in refunds of tax to low income earners.

However, there may be an impact on revenue as there is no requirement that dividends must be paid out of taxed profits to be exempt, whereas franking credits were only available under imputation where corporate tax had been paid. There does not appear to be a quantification of this impact in Singapore but the revenue impact may be minimised by the fact that, even under imputation, companies were able to distribute 'exempt dividends' where they did not pay tax due to the availability of a tax incentive under the *Income Tax Act* or the *Economic Expansion Incentives (Relief from Income Tax) Act*.

Clearly, some of the shortcomings identified with Singapore's previous imputation system are equally apparent in an Australian context.

On the other hand, the loss of refundable imputation credits and the possibility of restricting the tax deductibility of financing costs would have a significant impact on the capital markets in Australia and the funds management industry. The drivers behind the abolition of dividend imputation in Singapore are somewhat equivocal in an Australian context.

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[65] Economic Review Committee: Sub-committee on Policies Related to Taxation, The CPF System, Wages & Land*, Restructuring the Tax System for Growth and Job Creation,* p34 (2002)
[66] Tech, Tan How, 'Assessing the Impact of Singapore's Move to the One-Tier Corporate Tax System on Shareholders', *International Tax Journal* , pp19-28 (2006)

6.3 Assessing Australia's dividend imputation system

Clearly, in a domestic setting, the Australian imputation system eliminates the double taxation of corporate income distributed as dividends to resident shareholders, which reduces the bias towards debt financing. Equity is strengthened as the dividend is taxed at the progressive marginal tax rates.

Statistics show that at present the majority of Australian equity remains locally owned. The total value of equity on issue by Australian enterprise groups at 30 June 2007 was $2,195 billion of which non-residents held 29 percent and residents held 71 percent.[67] This potentially means the majority of investors in Australian companies benefit from imputation credits with a relatively smaller proportion of foreign residents that do not. Recent studies have shown that overall, the policy shift to an imputation tax system has resulted in a significant elimination of double taxation.[68]

Despite its efficacy of eliminating double taxation to Australian investors, the question that needs to be addressed is whether there are challenges with the imputation system that outweigh the benefits of retaining such a system, or whether the imputation system continues to complement Australia's other policy objectives.

We discuss below some of the more commonly cited challenges of Australia's dividend imputation system.

The first challenge of Australia's imputation system, faced by taxpayers and administrators, is that because particular investors may place a greater value on imputation credits than other investors, Australia has enacted various anti-avoidance measures to prevent trading in imputation credits. These provisions aim to prevent the streaming of franked dividends to shareholders who may benefit most (such as residents) and unfranked dividends to those who may not benefit (such as non-residents). The increased complexity of the tax system as a consequence of these provisions has been mainly borne at the corporate level as compliance costs[69]. The outcome that imputation credits under the Australian system benefit particular types of investors over others is not limited to situations involving foreign residents, but also, the ability for resident individuals on low marginal tax rates and complying superannuation funds to benefit from refundable franking credits.[70] Despite the complexity, the calls for tax reform in this area are for better targeted integrity measures, safe harbours and legislative clarity. It is not postulated this in itself warrants the abolition of imputation.

It has been argued that if the home country of a foreign investor does not give a tax credit for corporate taxes already paid in the host country under an imputation system, foreign investment in the host country would be discouraged. The tax treatment of resident and foreign shareholders would be non-neutral and potentially distort investment decisions (e.g. the amount of FDI, the investor's preferred sources of finance). Interestingly, a recent report produced by ASIC [71] noted that because foreign investors are not able to access imputation credits, this was, according to consulted entities, a relative disincentive for overseas portfolio investment in Australia. It is acknowledged that a full imputation system can result in a higher cost of capital for foreign investors as the imputation credit is only available to resident investors.[72] In an Australian context, this would be true if the home country of the foreign investor does not provide either a credit for tax paid in Australia or provides an exemption for dividends received from Australia (and other host countries), which may be the case for portfolio investment. However, these adverse taxation outcomes arise because of the home country tax regime, not the Australian imputation system. It should also be noted that for foreign investors (unlike domestic investors) Australia's CGT regime will often result in no CGT liability arising on the ultimate disposal of the shares.

From an Australian taxation viewpoint, because foreign investors derive limited benefit from Australia's current imputation system, this encourages a bias towards debt funding rather than equity funding by the foreign investor. For a foreign investor, the cost of Australian tax for debt is generally a withholding tax of 10 percent, which is lower than the underlying tax rate of 30 percent on corporate profits. From a foreign investor's home country perspective, debt funding into Australia may also be preferred over equity funding as a borrowing by the foreign investor to fund the investment into Australia may be deductible in the home country if it is used to fund debt, but not deductible if it is used to fund equity. However, excessive debt funding by a corporate in Australia is mitigated by Australia's thin capitalisation rules that seek to limit debt funding through the denial of interest deductions if debt funding exceeds the prescribed gearing limits. Thus, whilst it can be argued that the imputation system is again contributing to the tax system's complexity, this alone does not justify the abolition of imputation.

Although Australian resident investors obtain the benefit of imputation credits, there is a bias against Australian multinational companies earning income offshore as the current imputation system in Australia does not recognise either

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[67] Australian Bureau of Statistics, *1301.0 Year Book Australia 2008*, Statistical overview, Foreign ownership of equity in Australia, p724 (2008)
[68] Handley, J and Maheswaran, K, 'A Measure of the Efficacy of the Australian Imputation Tax System', *The Economic Record Vol 84 No. 264* (March 2008)
[69] Taylor, J, 'Development of and Prospects for Corporate-Shareholder Taxation in Australia', *Bulletin for International Fiscal Documentation 57* (August/September 2003)
[70] The Board of Taxation, *Review of the Taxation Treatment of Off-market Share buybacks Discussion Paper*, para 4.14 (July 2007)
[71] Australian Securities and Investment Commission, *Report 134: Enhancing capital flows into and out of Australia* (July 2008)
[72] OECD, *OECD Tax Policy Studies No.16*, *Fundamental Reform of Corporate Income Tax*, Part IV Chapter 9 (2007)

foreign dividend withholding tax or foreign company tax levied on the foreign source income of Australian resident companies i.e. there is economic double taxation.

As far back as in 1975, the Asprey Report identified this issue and the need to consider giving imputation credits for dividends paid from foreign source profits that had not borne Australian tax to encourage investment offshore.[73]

In 1993, the proposal to allow imputation credits for dividends paid from foreign source profits was debated at the BIE, *Dividend Policy Forum* of September 1993. In 1996, a report[74] was prepared by the BIE recognising the growth in outbound investment by Australian multinational companies and more generally, globalisation. It discussed whether a change was needed to Australia's imputation system so as not to unnecessarily impede Australian companies competing in a globalising world. The conclusion of the report as to whether the imputation system should recognise foreign taxes, was that unilateral action by Australia to remove the bias by modifying the imputation system so as to recognise foreign tax would leave the integrity of the Australian income tax base vulnerable to erosion.[75] The report also acknowledged the argument that the issue is one of international equity in tax sharing and that the removal of these distortions is best advanced through multilateral negotiations initially.[76]

The acknowledgement by Australian and New Zealand Governments of a possible move towards mutual recognition of imputation and franking credits between companies that invest in each other's country[77] would seem consistent with the approach (albeit on a bilateral rather than a multilateral approach).

It should also be noted that an imputation reform proposal for foreign taxes paid was tabled in 2002 when the Government engaged the BoT to consult on whether a change was necessary to Australia's dividend imputation system. The BoT recommended that domestic shareholders' tax relief should be provided for unfranked dividends paid out of foreign source income derived after the commencement date and that the relief should be by way of a non-refundable tax credit for 20 percent and without any requirement to trace foreign tax paid or incurred.[78]

The BoT also recommended, as an alternative, the streaming of foreign income to foreign shareholders (and, as a consequence, streaming of imputation credits to Australian shareholders). The idea of this proposal was to enable a swapping of credits between foreign and Australian shareholders, which is intended to indirectly achieve a result similar to giving Australian shareholders a credit for foreign taxes.[79] However, the Government at the time decided not to proceed with the implementation of the proposals, but did not rule out future consideration of the issues examined by the BoT.[80]

The bias against Australian multinational companies earning offshore income is arguably a more significant challenge to Australia's dividend imputation system in an increasingly globalised world. However, it is important to note that options have already been identified to reduce this bias (albeit there will be revenue effects) without abandoning the dividend imputation system altogether.

Accordingly, it is our assessment that the dividend imputation system has suited Australia's circumstances relatively well so far. Like all tax systems it has shortcomings, with some more minor than others. Whilst there is the suggestion that the abolition of dividend imputation could fund sizable reductions in the corporate tax burden, this is likely to come at a cost to other parts of the economy. A compelling case for change has not yet been made.

Equally, however, it is evident that challenges are emerging to Australia's current imputation system. It is our opinion that the AFTS Review should:

- conduct further analysis on the perceived challenges to Australia's existing dividend imputation system
- consider what reform options are available to the system and
- assess whether aspects of other corporate tax systems (either in whole, in part or a combination thereof) could be beneficially implemented in an Australian context.

With these recommendations in mind, the next section of this submission compares some of the advantages and disadvantages of alternate corporate tax systems.

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[73] Commonwealth Taxation Review Committee, *Commonwealth Taxation Review Committee Full Report 31 January 1975* (Asprey Report), para 16.74 (1975)
[74] Bureau of Industry Economics, *Report 96/8, Dividend Taxation and Globalisation in Australia* (June 1996)
[75] Bureau of Industry Economics, *Report 96/8, Dividend Taxation and Globalisation in Australia* , para 8.3.2 (June 1996)
[76] Bureau of Industry Economics, *Report 96/8, Dividend Taxation and Globalisation in Australia*, para 8.3.2 (June 1996)
[77] New Zealand Inland Revenue Department, *Australia, NZ agree to progress work on mutual recognition of imputation and franking credits*, Media Statement (17 July 2008)
[78] The Board of Taxation, *International Taxation, A Report to the Treasurer, Volume 1*, *The Board of Taxation's Recommendations*, Chapter 2 (28 February 2003)
[79] The Board of Taxation, *International Taxation, A Report to the Treasurer, Volume 1*, *The Board of Taxation's Recommendations*, Chapter 2 (28 February 2003)
[80] Australian Government, *Treasurer Media Release No. 032, Review of International Taxation Arrangements* (13 May 2003)

Recommendation Section 6.3: The AFTS Review should address whether Australia's dividend imputation system should be retained or improved.

The dividend imputation system has been an important part of Australia's corporate tax system and has served Australia well in the past.

There are now competing views as to its future. The views range from embracing imputation by giving franking credits to foreign taxes paid, to abolishing imputation thereby funding a lower corporate tax burden. However a compelling case for its abolition has not yet been made.

More consultation, analysis and modelling is required on the imputation system (and the alternatives) to reach an informed decision on such views.

7 International comparison - alternate corporate tax systems

Drawing on international experience of current systems used for the taxation of companies may guide Australia in evaluating whether existing company tax policy settings need to be radically reformed, merely fine-tuned or simply left alone.

With this end in mind, various alternate corporate tax systems adopted around the world are evaluated in the discussion below. This section of the submission appraises the allowance for corporate equity, shareholder allowance for corporate equity, allowance for shareholder equity, comprehensive business income tax, dual income, corporate cash flow and the flat tax systems.

The international experience is that the drivers of fundamental tax reform of corporate income tax systems are recognised to go beyond simply rate reductions and base broadening. Tax policy reform has generally centred around four major policy concerns:

- maintaining current levels of corporate tax revenue
- maintaining or creating an attractive investment climate
- reducing the (mainly financial) tax induced distortions and
- reducing tax complexity.[81]

Reducing tax induced distortions relates to addressing tax neutrality concerns in relation to debt and equity and between external and internal equity under a corporate income tax system. Many countries adopt different types of integration models for shareholder and corporate taxation to mitigate the magnitude of the potential distortion. Several countries have used alternate methods to reduce the taxation of dividends in the hands of the shareholders.

In the past, many OECD countries reduced shareholder taxation by giving a (partial) credit for tax paid at the corporate level, using imputation systems. Recently, there has been a shift away from imputation systems in some countries in Europe and to a significant extent, this has been the result of judgements by the ECJ concerning the discriminatory treatment of non-residents by most imputation systems[82]. This particular feature is not relevant in an Australian context (as it is not subject to any supranational laws).

Nevertheless, there has also been an economic impetus for moving away from an imputation system that has been demonstrated by non-European countries, such as Singapore in 2003.

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[81] OECD, *OECD Tax Policy Studies No.16*, *Fundamental Reform of Corporate Income Tax*, Executive Summary (2007)
[82] OECD, *Policy Brief, Reforming Corporate Income Tax* (July 2008)

Globalisation has meant that large companies can raise capital internationally and do not have to rely on domestic shareholders (who may derive the maximum benefits from an imputation system) for equity finance. Because foreign residents benefit less (or not at all) from imputation credits, it is argued that an imputation system does not reduce the cost of capital for such companies. A desire to promote the competitiveness of its resident companies and attract FDI might be achieved by eliminating imputation credits and using the money saved to reduce the corporate tax rate as had been done in Germany and Finland.[83] As discussed in earlier parts of this submission, a similar suggestion has been made in Australia involving the removal of an imputation system and reverting back to a classical system of corporate taxation to fund a reduction in the corporate tax rate in Australia.[84]

If Australia's current imputation system is to be modified, the imperative policy question becomes whether there is an alternative integration system of company and shareholder taxation that is (in whole or in part) a better platform, in terms of equity, efficiency and simplicity.

The next section of the submission evaluates various options.

7.1 Allowance for corporate equity

7.1.1 How it works

In a system known as the ACE tax system, a tax deduction is allowed at the corporate level for the return on equity, similar to the deduction for interest payments. The ACE tax system does not tax the 'normal' (market required) return on capital but does tax any profit in excess of that ('the economic rent').[85]

The ACE tax system aims to correct the different tax treatment between debt and equity by providing a deductible allowance for corporate equity in computing taxable profits. Hence, neutrality is achieved at the corporate level.

However, full neutrality between debt and equity may not be achieved if dividends, capital gains and interest payments are taxed at different rates at the individual shareholder level. Thus, in implementing an ACE tax system, full neutrality with respect to the corporate investment sources might require a reform of income taxes of capital income at the personal level as well. For example, in a domestic context, equity finance may be preferred over debt finance if capital gains are more favourably taxed at the personal level (either no CGT or a lower effective tax rate on capital gains) than dividends and interest payments.

The allowance for corporate equity equals the product of shareholders' funds (generally, this equals the company's total equity capital) and an appropriate nominal interest rate, for example, the interest rate on medium term government bonds. The interest rate or 'imputed return' should equal the interest rate that companies would have to pay if the new investment was financed with debt instead of equity. The allowance therefore approximates the company's normal profits and corporate tax is confined to economic rent, because corporate profits in excess of the ACE remain subject to corporate tax.[86]

In considering an ACE tax system, the advantages and disadvantages of such a system in the context of a country's domestic tax policies need to be evaluated.

7.1.2 Advantages and disadvantages

Advantages

In an open economy, the symmetric treatment of debt and equity may eliminate the need for complex thin capitalisation rules. Since companies get a deduction for an imputed interest on equity as well as for the interest on debt, multinationals have less incentive to undercapitalise a subsidiary operating in a country with an ACE tax system. Conversely, it is also claimed that multinationals no longer have an incentive to excessively finance their subsidiaries with debt because equity receives the same favourable tax treatment.[87] The symmetric treatment of equity and debt may also help solve the increasingly difficult problem of distinguishing between debt and equity for tax purposes. In this respect, the ACE tax system potentially simplifies a country's corporate tax system.

The fact that the ACE tax system is attempting to only tax those profits in excess of the normal profit is also consistent with taxing capital income concessionally to the extent of an inflationary or nominal return (as opposed to taxing the risk premium return).

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[83] OECD, *Policy Brief, Reforming Corporate Income Tax* (July 2008)
[84] Gruen, Dr N, *CEDA Information Paper 85,Tax Cuts to Compete - The influence of corporate taxation on Australia's economic growth*, Committee for Economic Development of Australia (CEDA) (2006)
[85] OECD, *Policy Brief, Reforming Corporate Income Tax* (July 2008)
[86] OECD, *OECD Tax Policy Studies No.16*, *Fundamental Reform of Corporate Income Tax*, Chapter 9 (2007)
[87] OECD, *OECD Tax Policy Studies No.16*, *Fundamental Reform of Corporate Income Tax*, Chapter 9 (2007)

Disadvantages

The ACE tax system may be seen as eroding the corporate income tax base.[88] Because of the narrower tax base, a higher tax rate (either through company tax or other taxes such as indirect taxes) needs to be set if the same amount of revenue is to be collected. However, a rate increase might have a negative impact on the location decisions of companies and on the amount of FDI.

The ACE tax system only taxes economic rents but this can still distort a company's decision that depends on the overall corporate tax burden. If an increase in a corporate tax rate is chosen as the way to compensate for the revenue loss due to the ACE allowance, this may provide an incentive for profitable companies to relocate their headquarters into a country that levies a lower corporate tax rate. There is also an incentive to shift economic rents to a low-tax jurisdiction by means of transfer pricing.[89]

If many shares in the domestic company are owned by tax-exempt institutional investors and by foreigners, the ACE tax system could result in a loss to the revenue compared to a scenario whereby an allowance is granted only to domestic shareholders.

In an international context, the impact of the ACE tax system for foreign corporate investors will depend on the tax treatment of foreign income in the company's country of residence and in particular, whether the foreign corporate investor is subject to a worldwide tax system or a dividend exemption system.

If the foreign investor is subject to a worldwide tax system, foreign interest payments and dividends might be taxed in the country of residence on an accruals basis in the home country but CGT might be deferred until the profits are realised. As a result, foreign shareholders may prefer that the company retain and reinvest earnings instead of distributing them as dividends. Equity then becomes a more preferred source of finance than debt under an ACE tax system. Thus, the ACE tax system only implements neutrality between debt and equity at the corporate level in the host country.

If the foreign investor is subject to a dividend exemption tax system and foreign dividends received are assumed to be taxed in the host country and therefore tax exempt in the home country, the normal return on equity, as opposed to interest payments, might escape taxation in both the residence and source country. Equity may become a more preferred source of finance than debt for the foreign corporate investor and hence, neutrality is not achieved. In the current global environment, as countries consider a move towards a dividend exemption system[90], this outcome is likely to be the more common scenario.

Clearly, there are also compliance considerations in working out how the ACE allowance is calculated on an annual basis. This could also be a practical disadvantage with an ACE tax system.

7.1.3 Case studies

Belgium

The ACE tax system adopted in Belgium came into force as of 1 January 2006.[91] Conceptually, a company is treated as if it had borrowed its own funds (equity) at a yearly rate equal to that of the ten-year government bond. This 'notional' interest is deducted from the tax base (called the 'risk capital deduction' or commonly known as the 'notional interest deduction').

The notional interest deduction system was introduced in part to attract new equity-funded entities and activities to Belgium and to provide a replacement for the pre-existing 'coordination centre regime'. The preparatory work on Belgium's notional interest deduction system shows the system was introduced for three reasons:

- to reduce the fiscal discrimination between debt and equity
- to maintain and further develop small and medium sized companies, an important part of Belgium's economy thought to benefit in particular from the notional interest deduction system and
- to be an alternative to the Belgium's coordination centre regime.[92]

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[88] Griffith, R, Hines, J and Sorensen, P, *International Capital Taxation - Chapter prepared for Reforming the Tax System for the 21st Century: The Mirrlees Review* (March 2008)
[89] OECD, *OECD Tax Policy Studies No.16*, *Fundamental Reform of Corporate Income Tax*, Chapter 9 (2007)
[90] For example, countries such as Canada, New Zealand, US, UK and Japan are considering (or have considered) a move towards a dividend exemption system.
[91] OECD, *OECD Tax Policy Studies No.16*, *Fundamental Reform of Corporate Income Tax*, Chapter 9 (2007); Healy, G and Berkovic, N, 'Company tax cuts better than credits', *The Australian* (11 September 2008)
[92] Reference made to Preparatory Works, *Parl. Doc., Kamer 2004-2005*, No 51-1778/001 at 4-6 in Haelterman, A and H Verstraete, 'The "Notional Interest Deduction" in Belgium', *Bulletin for International Taxation* (August/September 2008)

Generally, a Belgian coordination centre could only be established by certain multinational groups that only performed certain preparatory or auxiliary activities for the benefit of the group members, such as centralising financial transactions. The coordination centre regime offered a favourable tax treatment for a period[93]. The coordination centre regime was phased out following pressure from the EC. It is evident that many of the groups that used the Belgian coordination centre now use a Belgian company with application of the notional interest deduction system and therefore, the new system provided a transition for the Belgian coordination centres.[94]

The deductible amount under Belgium's notional interest deduction system is equal to the company's risk capital multiplied by the interest rate applicable to the 10-year long-term linear government bonds. A company's risk capital corresponds to its equity as it appears in its non-consolidated annual accounts of the preceding accounting year. This includes the company's capital, share premium, revaluation capital gains reserves, etc. The interest rate is adjusted annually and is the average rate of the year before the accounting period to which the taxable period refers. The reference rate for tax year 2008 (accounting period 2007) was 3.781 percent and for the tax year 2009 (accounting period 2008), the reference rate is 4.307 percent.[95]

Belgium's nominal corporate tax rate remains just below 34 percent after introduction of the notional interest deduction system.[96] The notional interest deduction system in Belgium, reduces the effective tax rate from 33.99 percent to an average range from 25 to 27 percent (or lower depending on the equity capital).[97] Thus, although Belgium's headline corporate tax rate is above the global average corporate tax rate of 25.9 percent[98], adopting an ACE tax system means that Belgium's tax system would generally produce a lower effective tax rate.

UK – 2008 tax reform proposals

There has been much discussion recently on the relative merits of adopting ACE tax systems in the European countries.

In particular, as part of the studies commissioned by the Mirrlees Review of the British tax system[99], it is recognised that globalisation and the growth of the financial sector require a new approach to the taxation of profits in a small open economy. Griffith, Hines and Sorensen (2008)[100] recommend exempting from taxable profits the normal rate of return (for example, the risk-free government bond rate) and this form of ACE approach would encourage investment.

Notwithstanding the arguments for increasing the corporate tax rate if an ACE tax system was to be adopted, Griffith, Hines and Sorensen (2008) propose that since the benefits arising from the stimulus of domestic and inbound investment is likely to exceed the immediate revenue loss as a result of implementing an ACE tax system, there is no rationale for raising the statutory corporate tax rate. In addition to this, there could be opportunities for international income shifting through transfer pricing with an increase in the corporate tax rate. Thus, the authors propose that the introduction of an ACE tax system should not be accompanied by a rise in the statutory corporate income tax rate.

Interestingly, the authors consider the adoption of an ACE tax system and blending it with elements of a dual income tax system that has been adopted in the Nordic countries (see below for further discussion) and an allowance for shareholder equity that exempts the normal return from tax.

At the shareholder level, the authors explain that if UK policy makers prefer to move towards a consumption based personal tax (like the shareholder allowance for corporate equity discussed below), exempting interest income from personal tax, allowing shareholders to deduct an imputed normal return on the basis of their shares before imposing tax on dividends and capital gains were recommended for further consideration as part of the reforms to the taxation of capital income. They argue that exemption for interest income would reduce the problem for enforcing residence-based taxation. It was also proposed by the Mirrlees Review that abolishing the personal dividend tax credit and aligning the combined tax rates on corporate and shareholder income with that on labour income could avoid some of the incentives to choose the legal form of a business for tax reasons.[101]

7.2 Shareholder allowance for corporate equity

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[93] Calculations estimate that the effective tax rate of a Belgium coordination centre was on average around 1.7 percent. Refer to Haelterman, A and Verstraete , H, 'The "Notional Interest Deduction" in Belgium', *Bulletin for International Taxation* (August/September 2008)
[94] Haelterman, A and Verstraete, H, 'The "Notional Interest Deduction" in Belgium', *Bulletin for International Taxation* (August/September 2008)
[95] Haelterman, A and Verstraete, H, 'The "Notional Interest Deduction" in Belgium', *Bulletin for International Taxation* (August/September 2008)
[96] KPMG International, *Corporate and Indirect Tax Rates Survey 2008* (September 2008) shows that from 1 January 2003 to 1 January 2008, the corporate tax rate in Belgium remained at 33.99 percent
[97] KPMG International, *Corporate and Indirect Tax Rates Survey 2008* (September 2008) see footnote on Belgium p17
[98] KPMG International, *Corporate and Indirect Tax Rates Survey 2008* (September 2008)
[99] The Institute for Fiscal Studies press release, *Globalisation demands reform of UK corporation tax, say studies prepared for the Mirrlees Review* (5 June 2008)
[100] Griffith, R, Hines, J and Sorensen, P, *International Capital Taxation - Chapter prepared for Reforming the Tax System for the 21st Century: The Mirrlees Review* (March 2008)
[101] Griffith, R, Hines, J and Sorensen, P, *International Capital Taxation - Chapter prepared for Reforming the Tax System for the 21st Century: The Mirrlees Review* (March 2008)

7.2.1 How it works

In contrast to the ACE tax system, the shareholder ACE tax system permits a tax allowance for the normal return on equity to be claimed at the shareholder level.

Under the shareholder ACE tax system, the allowance for corporate equity would be calculated in a similar way as under the corporate ACE tax system. However, instead of deducting the ACE from the corporate tax base, the company would divide the ACE by the number of shares. Each share would receive its part of the ACE and shareholders would be entitled to deduct the shareholder ACE allowance from the equity income tax base at the personal level.[102]

7.2.2 Advantages and disadvantages

Advantages

Providing an allowance at the shareholder level instead of the corporate level mitigates the concern that the entire tax burden on the normal return on equity could be deferred indefinitely, particularly if most OECD member countries do not tax capital gains at the personal level or they tax capital gains upon realisation (and often at a lower rate). This deferral would not arise under the shareholder ACE tax system because corporate income tax acts as a withholding tax for capital income on the normal return on equity at the personal level.

At the domestic level, neutrality between debt and equity would then be achieved if the capital income tax rate on interest payments at the personal level equals the corporate income tax rate.

If foreign investors can benefit from the ACE tax system, the shareholder ACE tax system has the same efficiency properties in an open economy as the corporate ACE tax system.[103]

Disadvantages

Equity with the shareholder ACE tax system may not be achieved, as foreign investors might not necessarily be able to benefit from the full allowance/credit if it would be allowed only against withholding taxes.

Similar to the ACE tax system, it has been argued that tax rates such as the corporate tax rate may need to be raised to implement the new system. The raising of the corporate tax rate might have a negative impact on the location decision of companies, on the amount of FDI and might induce companies to shift economic rents out of the country.

Given an international environment where countries compete over corporate tax rates, the required equality between the personal tax rate on interest payments and the corporate tax rate under the shareholder ACE tax system might limit the revenue that can be raised through the taxation of interest income.[104]

Compliance considerations for shareholders in being provided with the requisite information to prepare their tax computations is also likely to be a practical disadvantage.

7.2.3 Case studies

No countries were observed as having adopted the shareholder ACE tax system, which in itself suggests that its disadvantages may outweigh its advantages.

7.3 Allowance for shareholder equity

7.3.1 How it works

The ASE tax system introduces a tax deductible allowance for the normal return on equity at the shareholder level. This allowance for shareholder equity equals the value of the company's equity, for instance, the value of the company's shares, multiplied by an imputed return as, for instance, the after-tax interest rate on medium term government bonds.

The ASE tax system prevents the double taxation of the normal return on equity by providing tax relief for the normal return on equity, not at the corporate level as under the ACE tax system, but instead at the personal level.[105]

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[102] OECD, *OECD Tax Policy Studies No.16*, *Fundamental Reform of Corporate Income Tax*, Chapter 9 (2007)
[103] OECD, *OECD Tax Policy Studies No.16*, *Fundamental Reform of Corporate Income Tax*, Chapter 9 (2007)
[104] OECD, *OECD Tax Policy Studies No.16*, *Fundamental Reform of Corporate Income Tax*, Chapter 9 (2007)
[105] OECD, *OECD Tax Policy Studies No.16*, *Fundamental Reform of Corporate Income Tax*, Chapter 9 (2007)

A number of differences arise between the ASE tax system and the shareholder ACE tax system:

- The shareholder ACE tax system is a source based tax allowance while the ASE tax system is a residence based tax allowance. The shareholder ACE tax system applies to all equity financed investment in the source country, while the ASE tax system applies to the equity investment by resident shareholders either on their domestic equity investments or on their worldwide equity investments (as is the case in Norway).
- The shareholder ACE allowance is based on the book value of the company's shares while the ASE allowance is calculated using the value of the shares in the stock market. Thus, the tax revenues from the ASE tax system may be more volatile than under the shareholder ACE tax system. It may also imply that the administrative costs for implementing a shareholder ACE tax system may be lower and that it creates less opportunity for tax evasion.

7.3.2 Advantages and disadvantages

Advantages

The ASE tax system is tax neutral with respect to investment decisions and reduces the potential gains from income shifting by corporate owner managers.

If the (nominal) interest rate that is applied to calculate the ASE allowance equals the (nominal) interest rate that is paid as a reward for the debt and if the corporate tax rate equals the personal income tax rate on interest payments, the company will be indifferent between debt and equity as a source of finance in a closed economy.

Disadvantages

The debt/equity distortions continue to exist at the corporate level (thus, there continues to be a need to retain thin capitalisation rules). The ASE tax system is neutral with respect to the debt/equity choice only for domestic investors.

Because the normal return on equity is no longer taxed at the shareholder level, tax revenues may decline. To compensate the loss in revenue, it has been argued that a government might consider increasing the corporate tax rate. A rate increase might have a negative impact on the domestic amount of corporate investment, on international location decisions of companies, on the amount of FDI and might induce companies to shift the economic rents out of the country.

The ASE tax system puts tax revenues further under pressure because the corporate income tax rate should be equal to the personal income tax rate levied on interest payments.

The ASE allowance is calculated on the basis of the value of the company's shares. The tax revenue that a government will raise might be more volatile compared to the revenue raised under the ACE tax system, which uses the company's book value of equity to calculate the corporate allowance.

Shareholder income tax is neutral with respect to investment and financing decisions and with respect to decisions to realise a capital gain or loss provided full loss offsets are granted. However, administrative considerations and the need to constrain tax avoidance are likely to necessitate some limitations on loss offsets. In practice, it may be difficult to achieve full neutrality of the shareholder income tax.[106]

It would also appear that compliance considerations will be a significant practical disadvantage with the ASE tax system given the level of information required at the shareholder taxpayer level to prepare ASE allowance tax computations.

7.3.3 Case study

Norway

Prior to adopting the ASE tax system, Norway had a dual income tax system. It was characterised by a flat uniform personal tax on all forms of capital income levied at a rate equal to the corporate income tax rate.[107] As capital income and labour income was subject to different tax rates, income splitting was mandatory in Norway under the dual income tax system 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. This trend occurred in the 1990s and it was felt that the Norwegian income splitting system was undermined.

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[106] OECD, *OECD Tax Policy Studies No.16*, *Fundamental Reform of Corporate Income Tax*, Chapter 9 (2007)
[107] Sorensen, P, *EPRU Working Paper No. 03-06, Neutral Taxation of Shareholder Income: A Norwegian Tax Reform Proposal* , Economic Policy Research Unit, University of Copenhagen (July 2003)

In redesigning a new tax system, other forms of corporate-personal tax integration systems were rejected. The progressive taxation of personal capital income (i.e. returning to a comprehensive income tax where personal income from capital is taxed at the same marginal rate as labour income) was rejected primarily because of the desire to keep the personal tax rate on capital income in line with the corporate tax rate. The classical corporate tax system was rejected on the basis of the concern that full double taxation of corporate equity income would distort investment in small and medium sized Norwegian companies without access to the international stock market.[108]

As a result, Norway introduced the ASE tax system in 2006 to address the problems with the income splitting system.[109] The Norwegian model imposes a personal tax on the equity premium i.e. a personal tax on returns to shares in excess of the after tax interest rate on government bonds. The equity premium is included in the shareholder's taxable capital income.

The imputed return, known as the 'rate of return allowance' recently implemented as of 1 January 2006, is deducted from taxable shareholder income. The tax is levied on the realised income from shares after deduction of the RRA. The realised income from a share consists of the dividend plus any realised capital gain minus any realised capital loss.

The allowance is calculated as the purchase price of the share (on the stepped up basis – sum of the original acquisition price of the share and all the RRAs on the share not utilised in the previous years) multiplied by an after tax risk free interest rate of 2.1 percent in 2006. This rate is the yearly average of the after tax return on the interest on three month government bonds for that year. The RRA applies to the shares of Norwegian and foreign companies owned by resident taxpayers in Norway. The tax system replaces the previous imputation system.

This allowance prevents the double taxation of the normal return on equity by providing tax relief for the normal return on equity, not at the corporate level as under the ACE tax system, but at the personal level instead.

Interestingly, there were two main reasons why Norway rejected the ACE tax system:

- An ACE tax system is a form of progressive corporate income tax potentially imposing a relatively high average tax rate on highly profitable companies. It was argued that as highly profitable firms were often multinationals which bring important intangible assets to countries where they invest, it was considered not in Norway's interest to introduce a tax system that might deter such investors.[110]
- For Norwegian subsidiaries of parent companies headquartered in countries offering a foreign tax credit for corporate taxes paid in Norway, the rate of return allowance would not stimulate the incentive to invest in Norway but would just transfer revenue from the Norwegian to foreign governments.[111]

[108] Sorensen, P, *EPRU Working Paper No. 03-06, Neutral Taxation of Shareholder Income: A Norwegian Tax Reform Proposal* , Economic Policy Research Unit, University of Copenhagen (July 2003)
[109] Sorensen P, 'Can Capital Income Taxes Survive? And Should They?' *CESifo Economic Studies Vol 53*, *2/2007*, pp 172-228 (4 June 2007)
[110] Sorensen, P, *EPRU Working Paper No. 03-06, Neutral Taxation of Shareholder Income: A Norwegian Tax Reform Proposal* , Economic Policy Research Unit, University of Copenhagen (July 2003)
[111] Sorensen, P, *EPRU Working Paper No. 03-06, Neutral Taxation of Shareholder Income: A Norwegian Tax Reform Proposal* , Economic Policy Research Unit, University of Copenhagen (July 2003)

7.4 Comprehensive business income tax

7.4.1 How it works

The CBIT system was first proposed by the US Treasury in 1992.[112] The CBIT system is premised on the basic principle that there is only one level of tax on capital income earned by a business.

Under the CBIT system, dividends and interest paid by a business are not deductible and dividend and interest income are not assessable in the recipient's hands, be they other businesses or individuals. The CBIT tax base would otherwise be the same as an existing corporate tax base but the CBIT system would apply to all businesses, not just companies, and only very small businesses would be exempt from the CBIT system.[113] Business losses would be trapped at the entity level and would not be available for distribution to equity holders whether they are shareholders, partners in a partnership or individuals. The losses can be carried-forward and utilised in later income years as a deduction against business income. Given the broadening of the tax base under the CBIT system as compared to the then existing US corporate tax system, it was proposed that the rate under the CBIT system be aligned to the top marginal tax rate for individuals, which at the time, meant there would in fact be a reduction in the US corporate tax rate from 34 percent to 31 percent.

Tax preferences available for companies would be extended to all business entities under the CBIT system and any dividends and interest deemed to be paid out of preference income would be subject to tax either at the entity level or in the investor's hands. The analysis by the US Treasury indicated that either method noted previously had its merits but proposed shareholder-level taxation of distributed preference income because economic analysis undertaken evidenced that an entity level tax on distributions of preference income would create significant inefficiencies on corporate payout decisions. CBIT system entities would be required to maintain an Excludable Distributions Account to record whether distributions are paid out of taxed income or preference income and it was proposed that CBIT system entities would distribute taxed income prior to distributions of preference income. Interest and dividend income received from other CBIT system entities are examples of preference income that would contribute to the Excludable Distributions Account. Similarly, foreign source income shielded from tax due to exemptions or foreign tax credits would be treated as preference income.

Under the CBIT system, special rules would be necessary for financial institutions and insurance companies which had significant amounts of interest and dividend income which would be exempt from tax under the CBIT system. One proposal was that the operating expenses of such companies will only be deductible to the extent that they correspond to non-interest or dividend income, i.e. income that is subject to tax.

7.4.2 Advantages and disadvantages

Advantage

The key advantages of the CBIT system are that it removes certain biases which may exist under the corporate and individual income tax regimes that existed in the US at the time. In particular, the CBIT system equates the treatment of debt and equity from the perspectives of the issuer and the holder. The CBIT system also ensures that corporate and non-corporate businesses are taxed in the same way thereby eliminating any bias against operating a business in the corporate form. Finally, the CBIT system also reduces any tax distortions between retained and distributed earnings.

Disadvantages

The underlying principle upon which the CBIT system is based removes the distortions discussed above. However, the need to deal with practicalities means the CBIT system may just create other biases which did not exist under the corporate tax systems at the time.

Firstly, the proposed method of taxing preference income creates an incentive for CBIT system entities to retain rather than distribute preference income.

Secondly, the non-deductibility of interest expenses may result in CBIT system entities converting returns to rent or royalties which would be deductible expenses. The Treasury report suggested that such conversion or recharacterisation would depend on the market's ability to correctly price interest.

Thirdly, the CBIT system requires special rules for financial institutions and insurance companies as a significant portion of their income would be exempt from tax under the CBIT system.

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[112] US Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (1992)
[113] The US Treasury report recommended that only businesses with total business receipts of less than $100,000 would be exempt from the CBIT. The exception was considered necessary due to the difficulty in separating capital income from labour income in very small businesses.

Finally, the US Treasury report recognised that the taxation of capital gains on equity and debt investments creates special issues under the CBIT system. These issues are not resolved in the US Treasury report as it would depend on the exact CBIT model adopted and complementary rules such as the availability of dividend reinvestment plans.

7.4.3 Case studies

Whilst the CBIT system is the most comprehensive integration regime developed thus far it has yet to be adopted in its entirety by any country which in itself is suggestive that its disadvantages may outweigh its advantages. Some countries, such as Denmark and Germany have moved towards such a system by limiting the deductibility of interest. In its proposal, the US Treasury suggested that a move to a CBIT system would be done incrementally over a period of at least 10 years.

7.5 Dual income tax

7.5.1 How it works

The characteristics of a dual income tax system in its purest form are:

- a flat uniform personal tax on all forms of capital income, levied at a rate equal to the corporate income tax rate
- full relief for the double taxation of corporate equity income
- a broad tax base for capital income and corporate income, aiming to bring taxable income in line with true economic income and
- a basic tax rate on labour income equal to the capital income tax rate combined with a progressive surtax on high labour income.

7.5.2 Advantages and disadvantages

Advantages

The concept under a dual income tax system is to keep the capital income tax low in a small open economy faced with the possibility of capital flight. As capital becomes increasingly mobile across borders, there is growing risk that a high domestic capital income tax rate will induce taxpayers to move their wealth abroad. Separating the capital income tax rate from the labour income tax schedule allows policy makers to reduce the former to minimise the risk of capital flight (particularly, in relation to mobile capital such as interest, and possibly more mobile individuals such as expatriates).

Personal income tax is typically levied on the full nominal return to capital, including the inflation premium which just compensates for the erosion of the real value of nominal assets. Thus, capital income is considered to be overtaxed if it were taxed at the high top marginal rate applying to labour income. Applying a low flat tax rate to capital income is a pragmatic way of dealing with this problem.

Capital income accrues in many forms. Some of these are hard to tax for practical or political reasons. Lowering the tax rate on those types of capital income that can be taxed serves to reduce the distortions that arise when certain types of capital income cannot be included in the tax base. A low tax rate makes it easier to include realised capital gains in the tax base without discouraging and distorting asset trades too much.

Aligning the corporate with the personal tax rate on capital income and equalising marginal capital income tax rates across taxpayers eliminates the scope for those tax arbitrage activities that seek to exploit such differences in tax rates.

By taxing the return to saving, a conventional income tax tends to discriminate against those taxpayers who save a relatively large part of their lifetime income in the early stages of their life cycle. Reducing the capital income tax rate alleviates this discrimination.[114]

Disadvantages

There are a number of disadvantages with such a model, and indeed those same disadvantages resulted in Norway to move from such a system to an ASE tax system (refer above).

A dual income tax system requires that income be split into a labour income component and a capital income component. Both companies and individuals may find this practically difficult and an administrative challenge.

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[114] Sorensen, P, *EPRU Working Paper Series 2005-10*, *Dual Income Taxation: Why and How?'* Economic Policy Research Unit, University of Copenhagen (2005)

There may be an incentive to shift income from labour to capital if capital income is taxed at a much lower (marginal) rate than labour income. Thus, anti-avoidance requirements may be needed.

7.5.3 Case studies

The Nordic countries

The Nordic countries implemented dual income tax systems in the early 1990s which all exhibited common features. For example, capital income is taxed at a flat rate equal or close to the corporate tax rate and close to the labour tax rate in the first income bracket. Labour income is taxed progressively. Active owners, who are working in their companies as managers or primary workers are forced to split their business income into a labour and capital component.

Capital income is generally defined as the imputed return on the stock of business assets and the difference between business income and imputed returns is classified as labour income. The calculation of the imputed rate of return is defined in national tax codes and differs between Nordic countries.

All Nordic countries allow for integration of capital and labour income although there are considerable differences between the four Nordic countries, ranging from full integration in Norway and Finland to substantial double taxation in Sweden and Denmark.[115]

UK – 2008 tax reform proposals

As noted in Section 7.1.3 Griffith, Hines and Sorenson[116] explore the adoption of an ACE tax system and blending it with elements of a dual income tax system that has been adopted in the Nordic countries. For example, applying a low flat personal capital income tax to all income categorised as 'capital income'. Some reasons put forward in applying a low tax rate on capital income include:

- Capital income would include interest, dividends, realised capital gains and rental income. To stimulate saving for retirement, policy makers may wish to leave the return to such savings out of the tax base or apply a relatively low flat rate below the top marginal tax rate applied to earned income.
- One major reason for advocating a low tax rate on capital income is the high and growing international mobility of portfolio capital combined with the practical difficulties of enforcing taxes on foreign source capital income.
- Another justification for a low capital income tax rate is that the tax is typically levied on all of the nominal return to capital, including the inflation premium that simply serves to preserve the real value of nominal assets. The lack of inflation adjustment means that the capital income tax may become punitive even at a low rate of inflation.[117]

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[115] Genser, B, 'The Dual Income Tax: Implementation and Experience in European Countries', Ekonomiski Pregled, 57 (3-4) 271-288 (2006)

[116] Griffith, R, Hines, J and Sorensen, P, *International Capital Taxation - Chapter prepared for Reforming the Tax System for the 21st Century: The Mirrlees Review* (March 2008)

[117] The example given by Griffith, R, Hines, J and Sorensen, P, *International Capital Taxation - Chapter prepared for Reforming the Tax System for the 21st Century: The Mirrlees Review* (March 2008) is that suppose the nominal interest rate is 4 percent, the rate of inflation is 2 percent and the capital income tax on the nominal return is 50 percent, leaving a 2 percent nominal after-tax return. The real after tax return would then be 2-2=0, so the effective tax rate on the real return would be a confiscatory 100 percent.

7.6 Corporate cash flow tax

7.6.1 How it works

The CCFT system has been proposed as an alternative to existing corporate income tax systems which are based on accrual accounting rules. Under the CCFT system, the corporate tax is based on cash-flow accounting rules, similar to the GST. The CCFT system would apply to all business activity, not just businesses operated through a corporate structure. The CCFT system can be levied on different tax bases, the most common of which are the R-base or the R+F-base.

The R-base CCFT system only includes real transactions in the tax base. Real transactions are measured as the difference between the receipts from sales of real goods and services and the expenses from purchases of real goods and services required in the production process, including purchases of capital goods. The cost of financing any investments however is not deductible and therefore interest payments are treated in the same way as payments of dividends for tax purposes.

The R+F-base CCFT system includes non-equity financial transactions in the tax base in addition to real transactions. Non-equity financial transactions refer to borrowing and lending funds. Borrowers include the loan principal in the tax base and deduct interest payments and the principal when it is redeemed. Lenders deduct the principal when they make a loan and include loan repayments (both principal and interest) in the tax base. The R+F base is therefore equal to (sales + borrowed funds + interest received + loan repayments) – (purchases + interest paid + debt repaid + lent funds).

7.6.2 Advantages and disadvantages

Advantages

The CCFT system is promoted on the basis that it will improve simplicity by removing distortions in the tax system and stop the manipulation of the tax system through timing decisions. For example, the immediate expensing of capital expenditure removes the long problematic distinction between income and capital in tax law.

Another advantage of the CCFT system is that it eliminates the bias between debt and equity by treating the two sources of finance equally.

The CCFT system would be imposed on all business activity and not just corporate structures thereby eliminating any distortions in operating a business under the various forms such as a sole proprietorship, partnership or corporate structure.

Immediate expensing of capital purchases is considered to be beneficial for a number of reasons.

Firstly, as all investments are immediately deductible and there is no need to claim tax deductions for depreciation, the CCFT system eliminates any biases in relation to the types of investment projects and industries undertaken by companies.

Secondly, the immediate expensing of capital expenditure eliminates the need to adjust the cost base of assets for inflation. The impact of financial market imperfections which result in companies having to forego projects and reduce profitability are minimised because the tax gain realised with immediate expensing can be reinvested in the business.

Further, the immediate expensing of capital expenditure provides firms with an immediate tax gain that can be reinvested in the corporation. Tax under the CCFT system is not levied as long as the company continues to reinvest its earnings.[118]

Disadvantages

The CCFT system has the advantage of removing any bias for companies between distributing or retaining earnings as the CCFT system is levied on the investment's equity-financed return. However, as long as a company reinvests its profits, it will effectively not have to pay any tax under a CCFT system as the deductibility of the investment from the tax base cancels out the tax on the profits that are retained and reinvested. Therefore, the CCFT system effectively creates a bias between reinvestment and distribution of corporate profits.

To maintain neutrality, it will be necessary to keep the corporate tax rate constant over time. An announced reduction in the CCFT system rate would result in companies having an incentive to bring forward investment to obtain corporate tax

[118] OECD, *OECD Tax Policy Studies No.16*, *Fundamental Reform of Corporate Income Tax*, Part III Chapter 6 (2007)

deductions. On the other hand, companies will have an incentive to postpone investment if a government announces a future increase in a corporate tax rate.

It is also considered that by taxing economic rents, the CCFT system continues to distort corporate decisions which depend on the average corporate tax burden, such as location decisions. The immediate expensing of capital expenditure and the taxation of economic rents (not normal returns of investment) may result in companies undertaking inefficient investments.

Under the CCFT system, losses might be carried forward at an appropriate rate of interest to preserve the value of immediate expensing. This adds a layer of complexity that does not exist under other existing corporate income tax systems.

The analysis indicates that the CCFT system will result in lower tax revenues and is perhaps more appropriate in countries with low levels of corporate tax revenue. If the CCFT system were to be adopted, significant transitional measures will be required to mitigate the loss in corporate tax revenue.

As mentioned above, one advantage of the CCFT system is the supposed reduction in tax complexity due to the removal of distortions and biases in the corporate tax system. However, the research indicates that new loopholes and avoidance opportunities are likely to arise under the CCFT system negating the touted simplicity benefits of the CCFT system. Further, special rules are likely to be required for the financial services sector which will complicate the system.

Finally, the CCFT system raises two key issues in an international context. Firstly, a CCFT system may not qualify as an income tax and may require a renegotiation of tax treaties. If countries do not provide a credit for tax under a CCFT system, this would significantly discourage the flow of foreign investment into any country with a CCFT system.

7.6.3 Case studies

The UK and Norway levy taxes similar to a CCFT system on the petroleum sector (as does Australia via PRRT[119]) while Italy imposes a regional tax on business activities in the form of a CCFT system. The only country that currently adopts a CCFT system is Estonia, which levies a corporate tax on distributed profits. The paucity of examples where the CCFT system has been fully implemented is suggestive that its disadvantages may outweigh its advantages. It should also be noted that in Section 10 of our submission, we discuss the previous Australian proposal to adopt a TVM which had some elements of a CCFT system.

Estonia

Estonia introduced corporate taxation on distributed profits only in 2000. The distribution tax is levied on dividends and certain other corporate expenses which could be seen as hidden dividends, such as fringe benefits that are not subject to personal income tax and interest payments that are excessively high compared to the market conditions on similar debt obligations. The tax is payable by all companies resident in Estonia and permanent establishments of foreign companies in Estonia and is levied on distributions to resident and non-resident shareholders. Distributions to non-resident shareholders are not subject to any further withholding tax.

The Estonian CCFT system is internationally competitive, as tax is imposed at a rate of 21 percent and will be reduced to 20 percent in 2009. Estonia has also expanded cash-flow taxation to unincorporated businesses by allowing sole proprietors an immediate deduction for all expenses on the acquisition of fixed and current assets.

The Estonian personal income tax exempts dividends from tax at the shareholder level and realised capital gains on shares are subject to the flat tax rate on personal income which equals the tax rate on corporate distributions.

While the Estonian tax system has been said to be extremely successful in promoting economic development in Estonia, it should be noted that the system is complemented by payroll tax at a rate of 33 percent and VAT at a rate of 18 percent that contribute to the government's revenue collections.[120]

[119] Australian Treasury, *Architecture of Australia's tax and transfer system*, p263 (August 2008)
[120] OECD, *OECD Tax Policy Studies No.16*, *Fundamental Reform of Corporate Income Tax*, Part III Chapter 8 (2007)

7.7 Flat tax

The flat tax was first developed and formalised by economists Robert E. Hall and Alvin Rabushka in their seminal work '*The Flat Tax*' in 1985. Most flat tax systems currently adopted by countries are largely based on the Hall-Rabushka model although no country has adopted the Hall-Rabushka flat tax model in its entirety.

7.7.1 How it works

The flat tax is based on the principle that all income should be taxed once and only once, at a uniform low rate (Hall-Rabushka proposed a rate of 19 percent). The system would also include a tax-free threshold to ensure equity in the system. It was expected that millions of Americans would no longer pay any income taxes under the Hall-Rabushka flat tax.

Under the Hall-Rabushka flat tax, all income generated in the economy is classified as either wages (salaries and pension income) or business income (everything else). Importantly, savings and investment income is not subject to tax under a flat tax. Tax is imposed only on income generated in the economy, i.e. territorial taxation not residence based taxation.

Taxpayers would complete either one or both of the following 'postcard tax returns'.[121]

[121] Heath, A, *Flat Tax: Towards a British Model*, Stockholm Network and The TaxPayers' Alliance (2006)

Table 7-1 Personal income tax return

Line	Item	Figure	Calculation
1	Wages and salary		
2	Pension income and retirement benefit		
3	Total compensation		Line 1 + Line 2
4	Personal allowance (tax-free threshold)		
5	Number of dependants excl. spouse		
6	Total personal allowances for dependants		Line 5 x personal allowance for dependants
7	Total personal allowances		Line 4 + Line 6
8	Taxable compensation		Line 3 - Line 4 if positive, otherwise zero
9	Tax		Line 8 x Flat Tax Rate
10	Tax withheld by employer		
11	Tax due		Line 9 - 10 Line 10, if greater than zero
12	Refund due		Line 10 – Line 9, if greater than zero

Source: Heath, A, Flat Tax: Towards a British Model, Stockholm Network and The TaxPayers' Alliance (2006)

Table 7-2 Business income tax return

Line	Item	Figure	Calculation
1	Total proceeds		Proceeds from: a) sales of goods and services b) sale of capital equipment, structures and land; c) self-employment or partnership income.
2	Total allowable expenses		a) Purchases from other businesses of inputs required for production, including goods, services and materials; and b) Salary, wages and pensions; and c) Capital spending, including purchase of machines, property.
3	Taxable income		Line 1 - Line 2
4	Tax		Line 3 x Flat Tax Rate
5	Carry-forward from previous year		
6	Interest on carry-forward		Line 5 x interest rate
7	Carry-forward into current tax year		Line 5 + Line 6
8	Tax due		Line 4 - Line 7, if greater than zero
9	Carry-forward to next tax year		Line 7 - Line 4, if greater than zero

Source: Heath, A, Flat Tax: Towards a British Model, Stockholm Network and The TaxPayers' Alliance (2006)

7.7.2 Advantages and disadvantages

Advantages

The primary advantage of the Hall-Rabushka flat tax is of course that it promotes simplicity in the tax system. Tax returns are simple and easy to complete, reducing compliance costs for taxpayers and tax administrators. In the case of most individuals earning salary income only, it is likely their tax liabilities will be dealt with entirely under the PAYG system with little need for end-of year adjustments. The abolition of tax deductions contributes towards the simplicity of the tax system but may raise other problems which are discussed further below. The imposition of tax on a territorial basis rather than residence is also considered to improve the simplicity of the system.

Flat tax lobbyists also argue that lower tax rates will result in greater economic growth and increased tax revenues based on the Laffer Curve.[122] They also argue that a shift to lower tax rates is inevitable due to globalisation and tax competition.

The flat tax is said to be superior in removing distortions which exist under the current income tax system. Most importantly, by disallowing deductions for interest expenses, the Hall-Rabushka flat tax removes any bias for debt financing over equity financing.

Secondly, by allowing for the immediate expensing of capital expenditure and treating income from the sale of capital assets the same as other business income, the model removes some of the problems which arise due to the distinction between capital and revenue.

Thirdly, the system taxes all business income in the same way thereby removing any incentives to adopt one particular business structure over another (e.g. sole proprietorship, partnerships or companies).

Finally, the flat tax eliminates tax provisions which create tax advantages for certain behaviours and activities. Removing such provisions removes the incentive for taxpayers to misallocate resources merely to reduce their tax liability.

The system does not tax dividend and interest income thereby encouraging savings and investment rather than consumption. Existing income tax systems can effectively promote consumption over saving by taxing salary or business income and then taxing interest and dividend income when the original salary or business income is invested rather than consumed.

Proponents of a flat tax also argue that taxing all income at the same rate removes the inefficiencies created by the current progressive income tax rate structure for individuals which deters individuals from working more and earning more income due to the increasing tax burden. This effect of the progressive tax rate structure is considered to impede economic growth although little empirical evidence exists which proves that this is indeed the case. Economic studies indicate that the income-effect and the substitution-effect generally offset each other meaning that for every one person who chooses not to work an extra hour due to the tax burden, there is another person who chooses to work two extra hours to compensate for the tax burden.

Another advantage of the flat tax is that it incorporates welfare aspects into the determination of tax liability. Under other tax-transfer systems, welfare benefits might be dealt with separately from the calculation of an individual's income tax liability.

Finally, the flat tax is said to be superior because it reduces the opportunities for tax avoidance by removing the distortions that might otherwise exist under other tax systems. It also removes the incentive to avoid tax if imposed at a low rate.

Disadvantages

The main argument against a flat tax is that it is inequitable. The progressive income tax rate structure promotes vertical equity by ensuring that taxpayers with a greater ability to pay (i.e. those on higher incomes) bear a greater burden of tax. A flat tax rate structure means all taxpayers bear the same burden of tax. While some flat tax advocates argue the flat tax is equitable as higher income earners in fact do pay more tax in dollar terms, this argument does not address the burden of tax.

A second disadvantage of the flat tax system is the problems created by the abolition of deductions for salary and wage earners. This is said to be inequitable because it means taxpayers who effectively earn less income due to the expenses

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[122] Laffer, A.B, *Executive Summary Backgrounder No. 1765, The Laffer Curve: Past, Present, and Future*, The Heritage Foundation (June 2004). The Laffer Curve illustrates the basic idea that changes in tax rates have two effects on tax revenues: the arithmetic effect and the economic effect. The arithmetic effect is simply that if tax rates are lowered, tax revenues (per dollar of tax base) will be lowered by the amount of the decrease in the rate. The reverse is true for an increase in tax rates. The economic effect, however, recognises the positive impact that lower tax rates have on work, output and employment – and thereby the tax base - by providing incentives to increase these activities.

incurred in earning that income will bear the same tax burden as taxpayers who earn the same amount of income but do not incur any expenses related to the earning of income. The counter argument is that this problem may not be insurmountable and may result in employers paying for such expenses. The greater problem with abolishing deductions is said to be the effect on donations and charities. It is argued that some taxpayers would not give to charity if not for the ability to claim a deduction for donations.

As mentioned above, one of the advantages of the flat tax system is that it removes tax provisions that create preferences for certain behaviours and activities. However, critics of the flat tax argue that although such an outcome may be attractive, as a matter of practicality it is necessary for governments to intervene to promote investment in certain sectors (e.g. R&D concessions).

7.7.3 Case studies

There are currently 24 countries that adopt some variation of the flat tax system. None however, adopt the Hall-Rabushka model in its entirety. The countries which have adopted a flat tax include Hong Kong, former Communist states of Eastern Europe, those of the former of USSR, Iceland and Mauritius. Iceland, for example, has adopted a flat tax system with a 37.5 percent rate which cannot be considered low by any standards and goes against the basic tenet of the Hall-Rabushka model. Hong Kong has had a variation of a flat tax since 1947 but does not accord strictly with the Hall-Rabushka model as different rates are imposed on salary income and business income.

Many of the countries which have implemented a flat tax report high economic growth, low unemployment and increased tax revenues. However, the IMF cautions that there may not be a direct causal link between a shift to a flat tax system and these effects as there are many other factors (such as fundamental shifts in government policy, increased prosecution of tax evasion, real wage growth) which need to be considered in these countries at the same time as a shift to a flat tax system.[123] Hong Kong is perhaps the best case study. It must be noted however that Hong Kong has considerably less government spending than other countries.[124]

In conclusion, these alternate corporate tax systems do demonstrate the development in international thinking on the taxation of capital income that is becoming increasingly mobile in a globalised economy. Whilst a wholesale change to Australia's tax system may ultimately not be feasible (refer discussions in Section 10.1 on Australia's previous experience in developing TVM) there are features within these other systems that should be considered.

The appendices to this submission summarise the alternate tax systems discussed in this section.

The analysis in this section and the appendices reflect research undertaken in the preparation of this submission based on the theoretical expected outcomes under each system. A detailed evaluation of the alternate tax systems as implemented overseas was beyond the scope of this submission. Accordingly, this submission does not make specific recommendations for the adoption of a particular model for Australia

[123] Ivanova, A, Keen, M and Klemm A, *International Monetary Fund Working Paper* 05/16, *The Russian Flat Tax Reform* (2005); Keen, M, Kim, Y and Varsano, R, *International Monetary Fund Working Paper 06/218,The "Flat Tax(es)" Principles and Evidence* (2006)

[124] Mitchell, D, *Prosperitas Vol. VIII Issue 1, The Global Flat Tax Revolution: Lessons for Policy Makers*, Center for Freedom and Prosperity (February 2008)

Recommendation Section 7: The AFTS Review should further evaluate alternate corporate tax systems in the Australian context.

Whether the impetus be globalisation, specific regional objectives or macro-economic policy, it is recommended the AFTS Review carefully evaluate the merits of the following alternate corporate tax systems to determine whether such systems offer (in whole or in part) possible reform options that would be useful in an Australian context. In particular

- ACE
- ASE and
- dual income tax

appear to be tax systems that might contain features worthy of further consideration.

The evaluation would also consider the implications of retaining or improving the existing imputation system. Even aspects of the flat tax system might be useful in the context of developing a simplified tax regime.

8 Exploring corporate tax rate aspirations for Australia

Before examining corporate tax rate aspirations for Australia, it is worthwhile summarising some key observations made so far on corporate taxation.

Firstly, when adjustments are made to some of the more common measures of the corporate tax burden to accommodate particular factors in an Australian context such as superannuation and the imputation system, Australia's corporate tax burden and the general level of taxation of capital income is high by international standards. Thus, it is difficult to rationalise why the current corporate tax rate of 30 percent should be retained.

As at 1 April 2008, the annual KPMG survey of global corporate tax rates shows of the 106 countries surveyed, the global average (including countries across the OECD, EU, ASPAC and Latin America) was 25.9 percent.[125] Even if Australia's corporate tax rate was cut to 25 percent, it would at best align the corporate tax rate to the global average.

Secondly, the studies cited earlier support the proposition that a reduction in the corporate tax rate leads to second order benefits to the economy such as higher levels of economic growth and foreign investment that could potentially outweigh the short term revenue costs.

The studies cited also conclude that a 10 percent cut in the corporate tax rate has a one to two percent rise in GDP per capita per year and results in approximately a 10 percent increase in pre-tax wages in manufacturing. In addition, every one percent reduction in the corporate tax rate leads to an increase of approximately three percent in FDI.

Thirdly, Australia's dividend imputation system has been an important part of Australia's corporate tax system and has served Australia well in the past. There are now competing views on the fate of the imputation system. The views range from modification to the current system to provide Australian resident shareholders with franking credits for foreign taxes paid, to abolishing imputation completely to fund a lower corporate tax rate.

Finally, there are alternate forms of company and shareholder integration tax systems Australia could consider in addressing issues associated with high levels of taxation of capital income and achieving tax neutrality between debt and equity financing choices. Australia could learn from international experience given there are a few systems such as the ACE and the ASE tax systems that have been applied and tested in practice in particular countries as a preferred platform for corporate and shareholder taxation. Some countries have considered mitigating the threat of capital flight by adopting a relatively low flat rate separate from the progressive tax schedule applied to labour income along the lines of the Nordic dual income tax.

Given all of the above, 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.

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[125] KPMG International, *Corporate and Indirect Tax Rates Survey 2008* (September 2008)

A reduction to 20 percent may be considered too dramatic from the current 30 percent, thus consideration should be given to a phased reduction in the corporate tax rate. For example, a reduction from 30 percent to 25 percent as an interim measure and then to 20 percent over a period of time.

Such a reduction in the corporate tax rate should not necessarily be constrained by a policy of revenue neutrality. It is more important that projected economic and productivity benefits to Australia from such a reduction are factored into the analysis.

It is acknowledged that, depending on its magnitude, a reduction in the corporate tax rate would need to occur in the context of overall tax reform. It will require important considerations such as the impact to Government revenue.

Recommendation Section 8: Australia should have an aspirational goal of reducing the corporate tax rate from 30 percent to 20 percent and a rate of 25 percent as an interim measure.

We recommend the AFTS Review analyse the macro-economic and international investment benefits of a reduction to the corporate tax rate from 30 percent to 20 percent with a rate of 25 percent as an interim measure.

9 Promoting simplicity, efficiency and equity

Earlier sections of this submission have looked beyond Australia's national borders and assessed the international competitiveness of its corporate tax system.

However, within Australia's own borders there are other tax reform options that warrant review and examination. These are highlighted below with detailed comments provided in the later sections of this submission.

As countries seek to match each other on the headline corporate tax rate, an important differentiator may start to emerge, namely, the 'friendliness' of a country's tax system for the business end-user. Indeed, faced with an ageing population, Australia needs to ensure that the scarce human capital resources are devoted to improving our productivity in the creation of goods and services rather than trying to understand and comply with (what seems to be the generally accepted view) an overly complex corporate tax regime.

Experience from the RBT era indicates there is a substantial human capital investment that has already been made in our current tax systems. Greater focus on post implementation reviews of the RBT initiatives and the implementation of an annual care and maintenance program would be worthwhile developments to ensure the tax system is operating as intended, is logical and efficient from an end-user's perspective.

With Australia adopting IFRS as a single reporting language for entities preparing general purpose financial reports, consideration should be given to tax system changes that leverage, align and better interact with existing financial reporting information systems. Moreover, it is important in the context of the current reforms to capital markets and regulatory reporting that Australia is proactive in considering the interdependencies of taxation outcomes in the context of other reforms (be they regulatory, professional standards, etc).

There appears to be considerable scope in simplifying the tax systems within Australia's national borders having regard to the multiplicity of similar tax systems that currently exist across the Australian Federation. There are opportunities to reduce the number of taxes in Australia and/or harmonise the tax base and administration of existing tax systems.

The recent report of the Tax Design Review Panel[126] has made a number of useful recommendations to improve the processes of tax policy and legislative design. Improving the design process is also addressed later in this submission.

It is also important to recognise that tax policy reform is a 'continual improvement' process. For example, tax policy settings will need to be realigned as Government policy objectives emerge in response to the environmental challenges (and other challenges) of the 21st century.

The subsequent sections of this submission aim to provide further detail highlighting the potential productivity, simplicity, efficiency and equity gains that can be achieved from Australia's existing tax systems by:

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[126] Tax Design Review Panel, *Better tax design and implementation, A Report to the Assistant Treasurer and Minister for Competition Policy & Consumer Affairs* (April 2008)

- considering a number of tax base issues associated with existing financial reporting systems and capital market reforms (Section 10)
- reducing the number of taxes and harmonising tax bases where appropriate (Section 11.1, 11.2 and 12)
- enhancing the consultative processes for tax policy and legislative design for tax reform (Section 11.3 to 11.6
- exploring a number of personal tax initiatives (Section 13 and 14) and
- reviewing existing tax policy settings in light of the Government's climate change objectives (Section 15).

10 Tax base issues

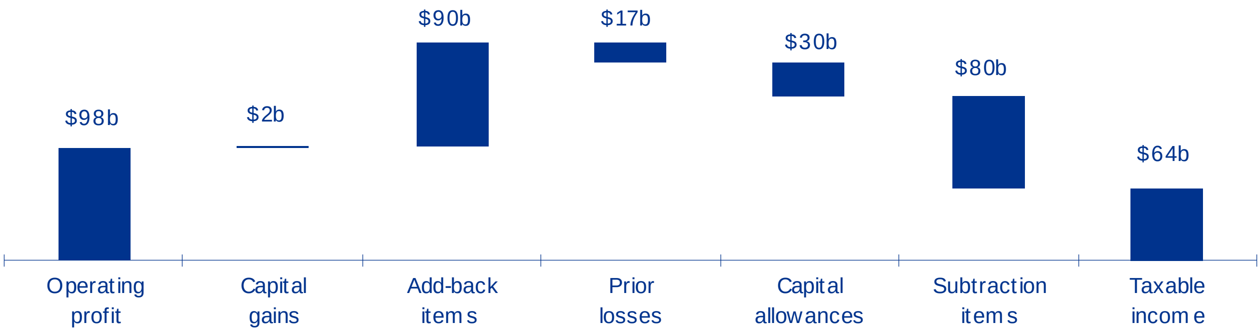
10.1 Leveraging financial reporting

The RBT[127] noted 10 years ago that the scale of adjustments to derive taxable income from a company's accounting profits is an indicator of the level of complexity within the corporate tax system.

Figure 10-1 and Figure 10-2 compare accounting profit with taxable income of all Australian taxpayer companies, including the broad reasons for the differences, at the time of the RBT and with more recent data.

The tables identify that there were, and still are, significant adjustments required to calculate the taxable income of a company by way of a reconciliation from its financial accounts.

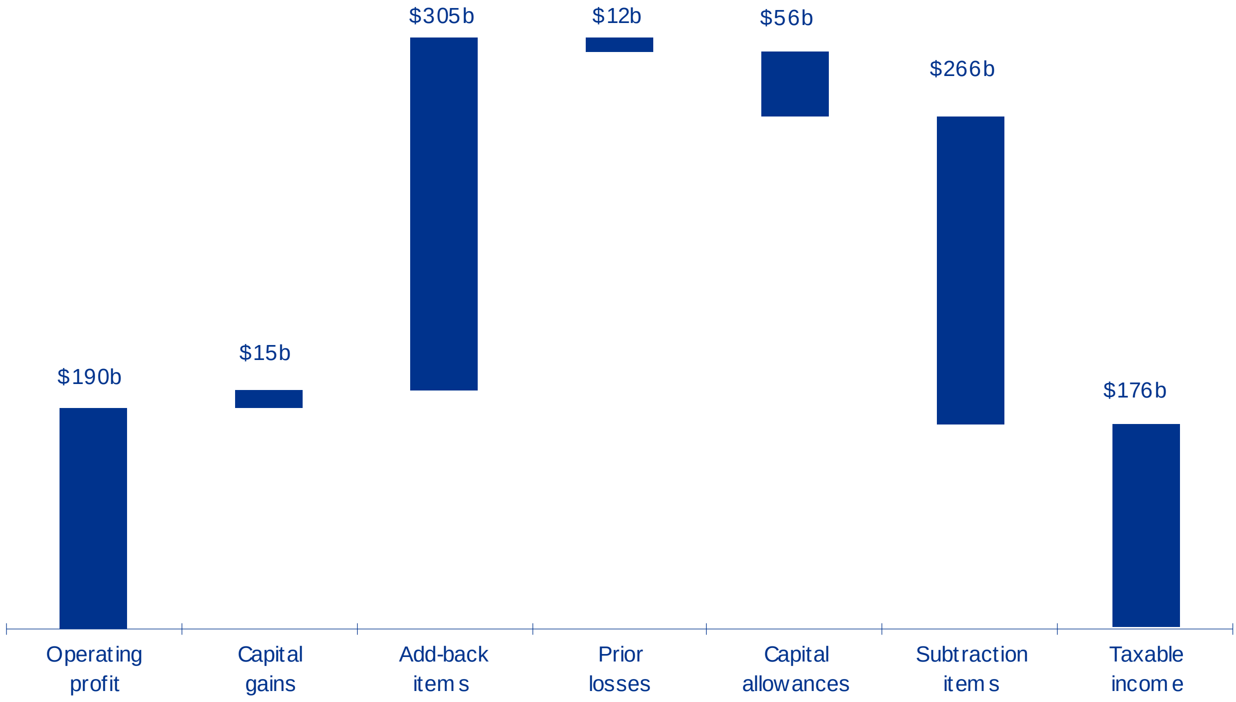
Figure 10-1 Taxable income and accounting profit 1995-96(a)



(a) Numbers do not add due to rounding. Numbers in $billions
Source: A Strong Foundation - Discussion Paper: Establishing objectives, principles and processes, Review of Business Taxation p21, (1998)

[127] Review of Business Taxation, *A Strong Foundation, Discussion Paper: Establishing objectives, principles and processes*, p20 (1998)

Figure 10-2 Taxable income and accounting profit 2005-06(b)



(b) Numbers in $billions
Source: Australian Taxation Office, Taxation Statistics 2005-06 (2008)

Having highlighted the complexity of the existing tax base for calculating taxable income, an original RBT recommendation was to adopt a TVM as the tax base for income tax purposes. The TVM is a variation of the corporate cash flow model discussed earlier in this submission. Taxable income was to be calculated on the basis of cash flows, but it also had regard to the changing values of assets and liabilities, with various other adjustments to reflect tax policy outcomes. The conclusion arising from Figure 10-2 is that the same level of complexity still exists today within the business income tax system, the question for consideration is whether TVM should again be evaluated as a model for Australia.

Some of the observations the BoT[128] made in recommending to the Government that it cease further work on the TVM were:

- Whilst there was general acknowledgement the income tax law was overly complex and did need substantial simplification, the ongoing benefits of adopting a significant change to the tax base calculation was, at best, uncertain.
- It would be a very large legislative task to complete.
- The substantial transitional costs and the loss of substantial human capital invested in the current tax system did not justify adopting a concept that was unproven.

The preference of the RBT then was for a less radical change that did not 'write off' the investment made in the current tax system. The feedback on TVM to the BoT at that time still resonates today where constant tax changes create a 'tax reform resistance'. Moreover, whilst analysing developments in alternate corporate tax systems is a worthwhile benchmarking exercise to ensure our tax system remains competitive, prior work undertaken in respect of the TVM system indicated that it had not passed a 'proof of concept' test.

Indeed, it could well be argued that, many of the benefits of the TVM could be more easily achieved via a greater alignment between taxation and accounting.

[128] The Board of Taxation, *Evaluation of the tax value method, A report to the Treasurer and Minister for Revenue and Assistant Treasurer* (July 2002)

In fact, the RBT also recommended that regard should be had to accounting principles in the development of tax legislation and that a process should be put in place to identify differences between the accounting and taxation treatment of profits with a view to better aligning these treatments[129].

This recommendation was put forward even though, at the time, accounting standards in Australia differed from international standards and the accounting rules were insufficiently comprehensive in some areas to be used for taxation purposes. Accounting for financial assets and liabilities was given as an example.

Reflecting on this RBT recommendation today, we have a much different picture when it comes to accounting standards. For capital market reporting, there is global convergence of financial reporting standards. Australia has also adopted IFRS. Moreover, whilst there is an IASB project underway to potentially modify IFRS for private entities, it is still likely that most of the recognition and measurement principles of IFRS will be retained[130].

In the context of reducing tax system complexity and compliance costs, greater alignment of tax outcomes with the financial reporting systems of taxpayers is worthy of further consideration by the AFTS Review.

This is not to suggest that the corporate income tax base would equal accounting profit. As the RBT noted, taxation and general purpose financial reporting are intended to serve different objectives. Not all taxpayers are required to prepare financial statements. Indeed only a small percentage of companies registered in Australia have any legal requirement to prepare and lodge general-purpose financial reports consistent with IFRS (albeit this small number is likely to be a substantial contributor to the tax system). Even where general purpose financial reports are produced by taxpayers there are any number of examples (e.g. taxation of dividends, foreign income, exceptions within the thin capitalisation rules etc.) which indicate there are, and will continue to be, differences between the two measurements of income.

Nevertheless, the new regime covering the tax timing treatments of financial arrangements (TOFA) suggests that, where tax policy moves away from a realisation basis, incorporating relevant financial accounting concepts into tax law design has its advantages. The commonality of this tax policy objective and accounting principles means that accounting concepts do offer a potential solution to both the integrity and compliance cost concerns for those entities producing general-purpose financial reports.

As noted earlier, Australia has adopted IFRS as the single financial reporting language for those entities preparing general-purpose financial reports. As these entities would typically represent a significant percentage (in dollar value) of taxes paid to, or, collected on behalf of governments, Australia should be drawing on financial reporting information when designing tax reporting and remittance procedures for this segment of business taxpayers.

Even if the reality is that there will be many instances where the final tax treatment is justifiably at odds with the accounting outcome, Australia could still make better use of financial reporting systems when remitting tax on an instalment basis. Rather than requiring the precise calculation of tax system income numbers at each instalment reporting date, it should be possible to design instalment systems that can more readily accommodate the use of financial reporting data, requiring only a single reconciliation to be performed as part of the final tax reporting assessment process.

Leveraging off the reporting information and data collection procedures already in use would ease the compliance burden of business taxpayers.

In summary, whilst wholesale use of financial reports as a tax base appears unrealistic, the RBT recommendation that ‘appropriate regard’ be had to accounting principles is still a sensible reform option. Where the tax policy objective is accruals taxation or the objective is to recognise / measure a tax asset or liability that similarly exists for financial reporting purposes, accounting principles may be useful in determining the tax base. In this regard the following questions come to mind:

- Do the Australian tax administration and regulatory financial reporting systems assist taxpayers by proactively identifying where there are differences between accounting and tax outcomes?
- Are legislative solutions considered for tax policy outcomes across a broad range of tax regimes that leverage off financial reporting obligations?
- Are tax policy and tax administration attune to the different financial reporting obligations for corporations law purposes?
- Is there sufficient interaction between tax administrators and the regulators responsible for accounting standards and the capital markets?

There are benefits (e.g. via reduced compliance costs) to be obtained where Australia’s tax system can leverage off finance reporting systems.

[129] Review of Business Taxation, *A Tax System Redesigned,* Recommendations 4.23 and 4.24, pp203 – 205 (July 1999)
[130] Australian Accounting Standards Board, *Invitation to Comment 17 – Request for Comment of IASB Discussion Paper Preliminary Views on an Improved Conceptual Framework for Financial Reporting: The Reporting Entity* (June 2008)

Recommendation Section 10.1: Greater leveraging off existing reporting systems should be pursued.

The RBT recommendation of 10 years ago still seems to withstand the test of time. Identifying the difference between the accounting and taxation treatments with a view to closer alignment (or at least greater awareness of the differences) has the potential to deliver compliance savings.

10.2 Tax and corporations law interactions

Tax base impacts are not immune from capital market reforms. Changes to capital market regulatory regimes may result in changes to the tax treatment of certain capital market transactions.

For example, it is suggested that the distributable dividend concept in the *Corporations Act 2001* may need changing[131], particularly as the fair value measurement rules under IFRS result in a greater number of adjustments to profit and/or shareholder's equity. The current rule is regarded by some as based on an outdated capital maintenance concept and Australia should be focusing on an overriding solvency test[132].

The concept of dividends for tax purposes is currently based around the same premise that distributions are paid out of profits. A distribution that is sourced from a company's share capital account is generally unfrankable.[133] Moreover, there is a myriad of dividend and capital streaming rules as well as integrity provisions surrounding franking and share capital tainting that have a similar historical tax policy setting.

There are arguments for retaining the profit requirement for tax purposes (e.g. revenue considerations surrounding the release of franking credits) and counter-arguments for the abandonment of a profit notion (aligning tax with corporations law outcomes mitigates complexity and would be consistent with capital market reforms between Australia and New Zealand).

Either way, the message is similar to the earlier discussion on the interaction between tax and accounting. The interaction of reforms to corporation laws with taxation outcomes needs to be calibrated.

Recommendation Section 10.2: The taxation outcomes resulting from other capital market regulatory reforms should be proactively considered.

The tax implications of capital markets reform should be a review priority of the AFTS Review.

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131 Section 254T of the *Corporations Act 2001* requires that a dividend may only be paid out of profits of the company
132 Australian Institute of Company Directors, *Position Paper No. 7 - A Solvency Based Test for Dividends* (February 2008)
133 An exception to this rule does apply to distributions from certain authorised deposit–taking institutions following restructures

11 Tax compliance and complexity

Complex tax laws and inefficient tax compliance systems impede productivity.

As the Architecture Paper[134] notes:

- Every extra hour spent by individuals and businesses grappling with tax rules is an hour not spent producing goods and services.
- Every dollar needed to fund tax-transfer administration systems is a dollar that needs to be raised through taxation.

The RBT[135] noted wide dissatisfaction and frustration by all stakeholders in the operation of the business tax system in 1999. The overriding reasons were said to be the complexity and ad hoc nature of the business tax system. It seems that not much has changed in almost 10 years, as the Architecture Paper echoes a similar sentiment.

It is true that the increase in globalisation, the complexity of business transactions and the natural tendency of individuals to maximise their after-tax position will always mean the business tax system will contain complex provisions. Nevertheless, it is possible to identify ways in which the tax system can be made simpler, less costly and more certain in its application.

11.1 Reduction in the number of taxes

The Architecture Paper identifies a large number of taxes levied by different levels of government in Australia, many of which raise little revenue[136].

The IPART NSW Draft Report has also assessed a number of NSW and Commonwealth taxes based on criterion of efficiency, equity, transparency, simplicity and robustness and (consistent with the findings in *Benchmarking Australia's Intergovernmental Fiscal Arrangements, Final Report*, (May 2006)) has found that the Government levies the more efficient, broadly-based taxes, while the States/Territories must generally rely on relatively inefficient, narrowly-based and sometimes highly cyclical transactions based taxes.[137]

The IPART NSW Draft Report found that purchaser transfer duty, insurance duty and fire services funding contributions rank amongst the worst of the NSW taxes when benchmarked against standard taxation principles[138]. Moreover, from an economic perspective, none of the NSW taxes assessed were very efficient in their current form, albeit two of the most

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[134] Australian Treasury, *Architecture of Australia's tax and transfer system,* p5 (August 2008)
[135] Review of Business Taxation, *A Tax System Redesigned, More certain, equitable and durable,* p102 (July 1999)
[136] Australian Treasury, *Architecture of Australia's tax and transfer system*, p310 (August 2008)
[137] Independent Pricing and Regulatory Tribunal of New South Wales (IPART NSW), *Review of State Taxation, Report to the Treasurer, Other Industries – Draft Report* p82 (June 2008)
[138] Independent Pricing and Regulatory Tribunal of New South Wales (IPART NSW), *Review of State Taxation, Report to the Treasurer, Other Industries – Draft Report* p5 (June 2008)

important taxes from a revenue-raising perspective (i.e. payroll tax and land tax) have the potential to be significantly more efficient.

The IPART NSW Draft Report concluded that there is scope to improve the design and mix of NSW taxes in general, and that there is scope to improve the efficiency of some of the most important taxes.[139] Importantly, this report emphasised that major benefits are likely to come from reform through federal-state cooperation rather than reform within a single State where the options for reform are limited.[140]

Recommendation Section 11.1: A strategy should be developed to eliminate inefficient taxes.

Compliance and administrative savings are available through the elimination of inefficient and inequitable taxes. The AFTS Review should produce a discussion paper for consultation on this topic in conjunction with COAG.

11.2 Harmonisation of tax bases

It is also apparent from the Architecture Paper and the IPART NSW Draft Report that whilst there are tax systems contributing substantially to the revenue base there are efficiency gains still on offer.

The IPART NSW Draft Report noted that some taxes are less suited to being levied at the state/territory level and are more effectively collected at federal level. This report notes that to be suitable for assignment to the state/territory level, the relevant tax should:

- be easy to administer at the state/territory level
- be capable of being imposed mainly on residents of the state/territory or local area and
- not raise problems of competition between State/Territory Governments or between the Government and the State/Territory Governments.

The IPART NSW Draft Report concludes that only a few taxes meet the above criteria (with property taxes listed as one example).[141]

In a later section of this submission on Federal/State taxation, we observe that the multiplicity of similar state/territory taxes, coupled with the lack of consistency in their tax bases, tax rates and tax administration, present significant opportunities to reduce complexity and compliance costs.

The current interactions between the Government and the State/Territory Governments to implement a standard business reporting system pursuant to which businesses can provide information to all levels of government is clearly a worthwhile initiative.

However, there are much greater benefits on offer when this initiative is combined with the streamlining of a number of similar state/territory taxes into one national tax regime with one national tax administrator.

We should retain state/territory tax functions to administer those taxes that have a geographic rationale (such as land tax and other property taxes). However, for other taxes that have a less defined geographic rationale, collecting those taxes at the national level appears to be the more appropriate mechanism.

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[139] Independent Pricing and Regulatory Tribunal of New South Wales (IPART NSW), *Review of State Taxation, Report to the Treasurer, Other Industries – Draft Report* p91 (June 2008)
[140] Independent Pricing and Regulatory Tribunal of New South Wales (IPART NSW), *Review of State Taxation, Report to the Treasurer, Other Industries – Draft Report* p91 (June 2008)
[141] Independent Pricing and Regulatory Tribunal of New South Wales (IPART NSW), *Review of State Taxation, Report to the Treasurer, Other Industries – Draft Report* p44 (June 2008)

Recommendation Section 11.2: A strategy should be developed to harmonise and/or consolidate a number of tax systems.

Compliance and administrative savings are available through the harmonisation and/or consolidation of similar tax regimes. The AFTS Review should produce a discussion paper for consultation on this topic in conjunction with COAG.

11.3 Tax policy design

The recent report of the Tax Design Review Panel[142] made 26 recommendations on how the quality of tax law could be improved with a broad theme of open and ongoing consultation with stakeholders, greater transparency surrounding the consultation and drafting process and increased communication with respect to how and when measures might be announced and enacted. Key recommendations encompassing these themes include:

- the Government to engage in pre-announcement consultation on tax policy design
- substantive tax changes to be developed by a tri-partite design team
- changes should be prospective and introduced within 12 months of an announcement and where retrospective changes are required they should be introduced within six months of an announcement
- greater priority to care and maintenance of the tax system
- adopt the BoT TIES recommendation and engage the BoT to advise on TIES priorities
- publish a forward work program on announced measures and
- monitor early implementation of new law.

These recommendations seem logical extensions of earlier initiatives by governments to engage in greater consultation in the design of tax systems and should assist in the development of tax policy.

There are, however, warning signs within the existing tax policy design processes that suggest there are impediments to successfully implementing such recommendations. These potential impediments (e.g. human capital constraints) are similar to some of the challenges generally faced in the Australian economy.

The concept of even greater open and ongoing consultation by the tax system stakeholders faces a number of hurdles. In this regard, it should be noted that:

- There is a significant backlog of tax measures announced but still not enacted by the previous Government[143] as well as the new Government's own legislative agenda, before we even get to a 'pre-announcement policy consultation' process.
- There is a perception that a number of the governmental stakeholders in the business taxation system (e.g. business taxation policy division within Treasury, Office of Parliamentary Counsel as well as oversight bodies such as the BoT) simply do not have sufficient 'head count' to handle the workload. In particular, it is perceived there is a shortage of legislative drafting resources and experienced policy designers.
- A shortage of practical business experience and a lack of appreciation of existing financial reporting systems with those involved in designing tax policy is likely to exacerbate the problem of workloads.
- Stakeholders are becoming increasingly specialised in their tax knowledge and it is becoming increasingly difficult to quickly identify and resolve interaction issues within the tax system.
- Increasingly the private sector is being asked to contribute more resources to consultation and to solve tax policy dilemmas or otherwise face the prospect of second best alternatives.

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[142] Tax Design Review Panel, *Better tax design and implementation, A Report to the Assistant Treasurer and Minister for Competition Policy & Consumer Affairs* (April 2008)
[143] Refer to *The Way Forward on Tax Measures Announced, but not Enacted, by the Previous Government* joint media release by the Treasurer and the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, Media Release No. 53, 13 May 2008

The tax profession is not immune from the ageing population challenges. Whilst the private sector wants and appreciates a greater say in the design of tax policy, their main business interests should lie in the production of goods and services.

Recommendation Section 11.3: Complement the implementation of the Tax Design Review Panel recommendations with additional tax policy design resources.

More experienced full time government resources are needed to convert the outcomes of a collaborative co-design consultation process into legislation and drive an annual care and maintenance program. These resources need to have, or have access to, the appropriate business skill sets.

11.4 Legislative design

As noted earlier, a greater appreciation of what is occurring in the development of other legislative regimes would assist in not only the development of tax legislation, but also in educating taxpayers where there are differences in outcomes between taxation and other regulatory regimes.

Further, by seeking to have less tax regimes it reduces the ongoing legislative development costs when it comes to reform of such tax systems.

However, at a very basic level the largest revenue generating tax system in Australia, income tax, still expands two separate Acts with drafting styles ranging from 1936 to today.

The RBT recommended an integrated tax code in 1999[144]. The ultimate demise of TVM plus the fact the earlier tax law improvement project of the 1990s could not challenge existing tax policy seems to have dampened enthusiasm for a single income tax Act[145].

Consistent with the theme of harmonising the taxation regime of various taxes, we need bolder initiatives than merely removing inoperative provisions from our current income tax Acts.

The development of a single income tax Act also gives rise to the question of whether a particular type of drafting style is superior. For example, it has been suggested that Australia is embracing a 'principles based' legislative design approach to its tax law drafting. It is considered that this results in clearer and concise tax legislation and is preferred to a 'black letter law' drafting style.

However, whilst it may be the case that tax policy design can adopt a principles based approach in the development of tax laws, recent experiences of converting policy into law using a 'principles' approach has not really shown any appreciable or practicable difference for the end user (i.e. taxpayers, tax advisors and the ATO).

Consider, for example, the exposure draft legislation for TOFA. This is said to be 'principles based' in its legislative design but ultimately the complexities of this regime have necessitated that amendments be made to address more and more issues such that it is difficult for a reader to identify any noticeable difference in the legislative style. Indeed the growing tendency to explain what is actually meant by the words of the law through the use of explanatory material, rather than embedding the guidance in the law itself, is lamentable. It can also mean that tax professionals are spending more, rather than less time, in trying to reach concluded views on tax legislation interpretation.

Ultimately, tax professionals are looking for legislation that has a reasonably high degree of certainty based on a commonsense reading of the words of the law and for the explanatory material to provide practical guidance rather than just paraphrasing what the legislation already has said. The 'brand' of drafting style is somewhat irrelevant.

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[144] Review of Business Taxation, *A Tax System Redesigned, More certain, equitable and durable,* Recommendation 2.1 (July 1999)
[145] Reference could also be made to recommendation 1.3, Review of Business Taxation, *A Tax System Redesigned, More certain, equitable and durable,* Recommendation 2.1 (July 1999) at p102 where the RBT recommended that a *Charter of Business Taxation* be adopted to establish an acceptable framework within which Australian taxation laws affecting business can be consistently developed and maintained.

The key points to note are that the legislation should have a logical structure; it should address the interaction issues with other parts of the tax law, and there is a preference, where possible, for the use of plain language and uniform definitions.

Recommendation Section 11.4: A single income tax Act should be produced.

The production of an integrated tax code with a consistent structure, language, and standardised definitions should be developed.

The production process should be able to challenge the existing tax policy underpinning the existing provisions.

11.5 Continuing refinement and review of legislation

Constant change within capital markets and businesses necessitates that tax reform is viewed as a continuous process with major 'health checks' being required every decade.

The RBT[146] considered there should be some form of annual assessment of the performance of the business tax system. The RBT also saw the need for an annual care and maintenance process which has also been highlighted in the recent report by Tax Design Review Panel[147].

A number of the RBT and Tax Design Review Panel's recommendations highlight the need for earlier 'post implementation reviews' of substantive tax changes to ensure they are operating as intended and that appropriate administrative products and guidance materials are in place.[148] Australia needs to ensure there is a more active post implementation review program in place to complement an annual care and maintenance process. The substantive RBT amendments since 1999 should be the initial focus of a post implementation review program.

Recommendation Section 11.5: Tax system reform processes should be ongoing.

The current recommendations to implement an annual care and maintenance process for tax systems should be introduced. A post implementation review of the substantive RBT amendments since 1999 should be undertaken.

11.6 Tax administration

Clearly tax administrators have a role to play in mitigating the level of complexity within the tax system. As noted earlier, if similar taxes levied in different jurisdictions throughout Australia were converted to a single tax code then there would be efficiency gains in having a single administrator. A single process of legislative guidance, assessment, payment, dispute resolution etc, could be accommodated under a single administration system.

Further, whilst the current division of responsibility between tax administration and tax policy appears logical, greater transparency of the tax administrator's views on tax law policy and complexity would seem beneficial to a system adopting an annual care and maintenance process.

It is the administrators, like the Commissioner of Taxation, that have the most complete knowledge on matters such as:

- FAQs asked by taxpayers
- common errors made by taxpayers or indeed tax officers
- areas of law resulting in frequent disagreements between taxpayers and administrators and
- areas of the law where the administrator considers tax outcomes are uncertain.

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[146] Refer Review of Business Taxation, *A Tax System Redesigned, More certain, equitable and durable,* p118 (July 1999)
[147] Tax Design Review Panel, *Better tax design and implementation, A Report to the Assistant Treasurer and Minister for Competition Policy & Consumer Affairs*, Recommendation 16 (April 2008)
[148] Tax Design Review Panel, *Better tax design and implementation, A Report to the Assistant Treasurer and Minister for Competition Policy & Consumer Affairs*, Recommendation 22 (April 2008)

Clearly at the moment the ATO is identifying and engaging with Treasury on a range of policy issues, albeit mainly on a confidential basis. The opportunity for more transparent disclosure of the ATO's views surrounding existing tax policy is worthy of further consideration.

Recommendation Section 11.6: Tax administrators should form an integral part of the development of tax policy and their involvement in the process should be more transparent.

Further consideration should be given to whether tax administrators should have a more public role in tax reform debate that complements an annual care and maintenance program of the tax system.

12 Federal/State taxation

12.1 The number of tax systems in Australia

The Architecture Paper highlights that there are many tax systems in Australia managed by layers of Government tax administration[149].

It is observed that for individuals, their interaction with the Australian tax-transfer system is typically in the State/Territory they reside. The multiplicity of transfers provided at different levels of government can make it time consuming to understand an individual's entitlements and obligations.

In contrast, a business that operates nationally or across several jurisdictions:

- has to comply with a much wider range of tax systems
- faces a higher burden of complexity due to differences in the way similar taxes are being imposed in different jurisdictions and
- faces a higher burden of complexity due to differences in the administrative procedures applied to the way similar taxes are collected.[150.]

There appears to be significant scope to reduce the tax-transfer system complexities and to achieve efficiency gains by adopting a greater coordinated approach to tax-transfer systems across Australia.

Consider for example the existing consumption taxation arrangements in respect of GST. Pursuant to the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations the revenue collected from GST is distributed among the States and Territories. The ATO has a service agreement with the States and Territories in relation to the collection and administration of the GST legislation, with the cost of administering GST being recovered from the States and Territories. The provision of GST revenue to the States and Territories allowed for the abolition of a number of inefficient State taxes as part of its introduction.

As the Architecture Paper observes:[151:]

- income tax was handed to the Government during the crisis of World War II
- payroll tax was previously a national regime and
- the opportunities for the States and Territories to introduce new forms of taxation are limited and their current array of taxes includes taxes that are transaction based or levied on relatively narrow tax bases.

Competition amongst the States/Territories can achieve efficiency gains for the economy. However, it is also true that inter state taxation competition faces a similar phenomenon to that of the global taxation of companies and the 'race to the bottom' witnessed in the last decade[152].

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[149] Australian Treasury, *Architecture of Australia's tax and transfer system*, p10 (August 2008)
[150] Australian Treasury, *Architecture of Australia's tax and transfer system*, p319 (August 2008)
[151] Australian Treasury, *Architecture of Australia's tax and transfer system*, pp291-2 (August 2008)

There is a significant 'win/win' outcome from a harmonisation approach to similar tax-transfer systems.

For taxpayers:

- reducing the number of taxes across Australia that individuals and businesses must interact with and
- streamlining of compliance costs.

For governments:

- tax law development as well as administrative reporting and payment procedures can be standardised and
- the costs of tax system administration can be reduced through economies of scale.[153.]

Whilst the Federal and State/Territory Governments are already involved in a process of reducing the regulatory burden, the Architecture Paper notes[154] a broader reform agenda provides the opportunity to take a more systematic view of the tax-transfer system.

The IPART NSW Draft Report[155] also notes that to overcome the various legal, institutional, policy and practical constraints on tax reform at the state/territory level, cooperation with the other States/Territories and between the States/Territories and the Government is necessary. This report notes that a national tax reform agenda would be consistent with the current Government's stated tax policy goals of maximising individual incentives, enhancing workforce participation and improving Australia's international competitiveness.

Thus, there appears to be considerable scope with a number of state/territory taxes impacting businesses to remove the more inefficient taxes and harmonise the tax base of others.

The Architecture Paper also highlights that components of the federal tax-transfer system would also benefit from a similar review. The administrative processes associated with the transfer system appear to be considerably more fragmented than the federal income tax system and the number of different federal and state/territory transfer payment arrangements would clearly benefit from greater standardisation and coordination.

Australia's system of federation has resulted in the incremental development of a tax-transfer system that is not in the best interests of a national economy facing the challenges of productivity constraints and an ageing population.

Recommendation Section 12.1: Consistent with the Recommendations in Sections 11.1 and 11.2 opportunities exist to reduce the number of taxes and the number of tax administration systems.

The AFTS Review in conjunction with COAG should evaluate the continuing role of all state and federal taxes with a view to streamlining the taxes and associated administration.

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[152] KPMG International, *Corporate and Indirect Tax Rates Survey 2008* (September 2008).
[153] Australian Treasury, *Architecture of Australia's tax and transfer system*, p309 (August 2008) has estimated that the administrative cost of the ATO and State Revenue Offices were around $2.9 billion in 2006-07 and the administrative cost of Centrelink was around $2.5 billion in 2006-07. Moreover, *Chart 2.12: Administrative framework of the tax-transfer system* highlights the level of fragmentation of administrative systems involved in the current tax-transfer systems.
[154] Australian Treasury, *Architecture of Australia's tax and transfer system*, p320 (August 2008)
[155] Independent Pricing and Regulatory Tribunal of New South Wales (IPART NSW), *Review of State Taxation, Report to the Treasurer, Other Industries – Draft Report* p136 (June 2008)

12.2 Payroll tax case study

Payroll tax was ceded to the States/Territories by the Government in 1971[156] in response to State/Territory requests for access to income tax. Despite various commitments and endeavours by State/Territory Governments to harmonise their payroll tax regimes, complexity still exists.

Issues arising from the current arrangements include:

- Whilst there has been some harmonisation of all payroll tax regimes of the States/Territories (with NSW and Victoria having identical provisions) we are still left with different rates and thresholds (see Table 12-1) and multiple state and territory revenue offices administrating these similar regimes.
- Unnecessary legislative and administrative complexity is therefore created when organisations have operations in more than one State/Territory.
- The level and nature of compliance activity undertaken by multiple state and territory revenue offices varies considerably and there is no single source of administrative guidance.

Table 12-1 Payroll tax rates & thresholds as at 1 January 2009 and Revenue for 2006-07

	NSW	Vic	Qld	WA	SA	Tas	NT	ACT
Rate (%)[(a)]	5.75	4.95	4.75	5.50	5.00	6.10	5.90	6.85
Exempt threshold ($)[(a)]	623,000	550,000	1,000,000	750,000	552,000	1,010,000	1,250,000	1,500,000
Revenue ($m)[(b)]	5,653	3,479	2,216	1,607	845	212	128	225

(a) *Table 2.18: Interstate comparison of taxes, 2008- 09 in Architecture of Australia's tax and transfer system, Commonwealth Treasury, August 2008*
(b) *Taxation Revenue, 5506.0, 2006-07, Australian Bureau of Statistics, April 2008*

The policy objective should aspire for the eventual abolition of payroll taxes. Research undertaken by the Institute with SMEs suggests that payroll tax is viewed as a significant disincentive to employment. However, it is recognised the significant extent to which the States/Territories are currently reliant upon payroll tax as the largest single own-source revenue, specifically:

- total payroll tax revenue for 2006-07 was $14,366 million and
- the Commonwealth Grants Commission indicates[157] that payroll tax constitutes on average 25 percent of State/Territory own-source revenue.

Recommendation Section12.2: A single payroll tax regime administered on a national basis should be considered and Australia should aspire to the eventual abolition of payroll tax.

Australia should return to a single payroll tax regime administered nationally, on a similar basis to GST. Compliance would be enhanced through the data matching capabilities of the ATO, matching payroll tax obligations with activity and PAYG remittances.

Ultimately, Australia should aspire to the eventual abolition of payroll tax.

156 *Pay-Roll Tax (Termination of Commonwealth Tax) Act 1971*
157 *Figure 2-5 State own-source revenue — annual average percentage of total for 2002-03 to 2006-07 (all States)* in *Relative Fiscal Capacities of the States 2008*, Commonwealth Grants Commission, 2008

Key features of payroll tax reform might include:

- The revenue allocated to the States/Territories according to an agreed formula, similar to, but not necessarily identical to the Commonwealth Grants Commission formula for GST revenue.
- Similar to the GST arrangements, the States/Territories would have input into the tax base, exempt threshold and the tax rate, with a special majority required to make substantive changes.
- The ATO would be responsible for administration and compliance activity. Organisations would remit payroll tax obligations through periodic returns on the BAS.

The key benefit of the reform of payroll tax arrangements would be in productivity, through the elimination of the costs associated with eight different payroll tax regimes.

13 Personal taxes

13.1 Personal tax rate aspirations

The Government has indicated that the AFTS Review needs to have regard to its aspirations for personal income tax which are shown below.

Table 13-1 Current and Government aspirational tax rates

2008-09		Aspiration (2013-14)	
Taxable Income ($)	**Rate (%)**	**Taxable Income ($)**	**Rate (%)**
0 - 6,000	0	0 - 6,000	0
6,001 - 34,000	15	6,001 - 37,000	15
34,001 - 80,000	30	37,001 -180,000	30
80,001 - 180,000	40	180,001+	40
180,001+	45		

Note: This table shows the rates that are applicable for Australian resident individuals but excludes the Medicare Levy
Source: Income Tax Rates Acts1986 and ALP A Tax Plan for Australia's Future (2007)

Observations arising from the Architecture Paper and the current personal tax system are as follows:

- The Government's aspirational personal income tax goals may need to be fine-tuned having regard to the corporate tax rate aspirations outlined in Section 8. For example, the taxable income range of $37,001 - $180,000 has an aspirational personal income marginal tax rate of 30 percent, which is the same as the current corporate tax rate. Any reduction in the corporate tax rate may require a review of the aspirational personal income marginal tax rates.
- The alignment of the maximum marginal tax rate with the company tax rate appears an unlikely medium term outcome. Thus, some complexity in our tax-transfer systems will be required to mitigate the inherent incentive to move labour income into corporate structures.
- There appear to be opportunities to harmonise some of the different characteristics that are reflected in the current personal tax system as compared to the transfer systems (e.g. harmonisation of various income and asset tests, assessment processes and possibly even consideration as to whether taxation of the individual could be on a family basis).
- There needs to be a focus on EMTRs at both the lower income levels (to encourage participation) as well as higher levels (to encourage longer participation in the workforce) to ensure Australia is maximising the rewards for participation in the workforce in the face of an ageing population.

- The household assistance package for the proposed CPRS[158] should be in addition to the above personal income tax rate aspirations and may even be able to be structured so as to complement incentives for workforce participation.
- The importance of a highly skilled/trained workforce, particularly one that can adapt to economic changes, suggests further incentives that focus on encouraging self education are warranted.
- With a personal marginal tax rate aspiration of 30 percent up to $180,000, existing tax systems which levy taxes at the highest personal marginal tax rate are becoming increasingly inequitable. A case in point is the FBT system.
- The merits of an optional tax return system for taxpayers who have all their income subject to withholding and reporting at source, should be investigated. This may require extending the withholding of taxes at source to include interest on bank deposits.

13.2 Fringe benefits tax

There have been a number of calls over the years for reform to the operation of the FBT regime, including:

- Recommendations as part of the RBT in 1999 that, inter alia, fringe benefits count as employee income so that fringe benefits provided to an employee are taxed to the employee[159].
- A report in 2006, commissioned by the Institute and written by Professor Neil Warren, Atax, Faculty of Law, University of NSW, advocating economic, efficiency and equity simplicity gains can be obtained from reforming the FBT system. The report recommended, inter alia, that fringe benefits should be taxed in the hands of employees and subject to their personal income marginal tax rate.[160]

The Architecture Paper notes[161] that Australia is only one of a few countries to levy a separate FBT rather than embedding it into the personal tax system. Moreover, Australia then has a reportable FBT system that is then used for means testing in transfer payment programs. Australia also has the complexity of a fringe benefits system which gives rise to non-deductible but no FBT outcomes; deductible but FBT outcomes; and, special rules for fringe benefits tax in the not-for-profit sector.

In addition, as noted above, a FBT system that is levying tax at the highest marginal tax rate is inequitable when consideration is given to the Government's personal tax rate aspirations.

Recommendation Section 13.2: The AFTS Review should revisit the earlier calls for reform to the taxation of fringe benefits.

There are strong arguments to support the view that fringe benefits should form part of the tax base in the personal income tax system.

Revisiting the earlier work performed in this area would provide the opportunity to improve the equity of the FBT regime and at the same time allow for the FBT base to be simplified.

Such a review also offers the potential of removing an entire tax regime (whilst still resulting in fringe benefits being subject to tax) and improving the interaction of the tax system with the means testing processes within the transfer system.

13.3 An expanded, simplified tax system

The prosperity that has accompanied Australia's booming terms of trade has meant that an increasing number of Australians are accumulating wealth and acquiring new types of investment assets. They are also able to access other forms of funding apart from their own savings.

A consequence is that more individuals and small businesses are finding they have to interact with more provisions of the tax system. Often these provisions are more complex in nature.

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[158] Department of Climate Change, *Carbon Pollution Reduction Scheme Green Paper* (July 2008)
[159] Review of Business Taxation, *A Tax System Redesigned, More certain, equitable and durable* (July 1999)
[160] Warren, N and ICAA, *Fringe benefit tax design: decision time* (2006)
[161] Australian Treasury, *Architecture of Australia's tax and transfer system*, p24 (August 2008)

On the other side, administrators are spending more of their time on educational/guidance material.

This added complexity hits small businesses particularly hard given they are both a taxpayer in their own right and a collector of other peoples' taxes on behalf of the Government. There needs to be a redefinition of 'the new small' for an expanded simplified tax system(s). It should encompass a larger population of businesses and could be harmonised across a number of tax regimes and possibly other regulatory regimes. Tax systems should be developed that allow such businesses to focus on the production of goods and services rather than trying to understand and comply with an onerously complex regulatory burden.

Recommendation Section 13.3: The AFTS Review should consider the redesign of the existing 'simplified' tax system and revisit the scope of this system.

Again, developments in other regulatory regimes provide opportunities for harmonisation. For example, the recent initiatives to reduce the financial reporting burden for private entities means there should be opportunities for coordination of tax responses in a manner that complements other regulatory regimes.

14 Superannuation contribution levels

An ageing population in years to come will place a strain on Australia's transfer system. It is therefore important to review whether the current superannuation levels are adequate and will provide the requisite level of savings so that increasingly Australians will have more of their retirement needs self-funded rather than relying on Government support.

The superannuation guarantee was introduced in 1992 and a ten-year phase in of the superannuation guarantee minimum contribution rate was completed in July 2002 with the rate now at nine percent. The impact of the superannuation guarantee is to defer part of an employee's remuneration into provision for their retirement income.

The previous Government contended that at nine percent there was a balance between employees forgoing current consumption for increases in living standards after retirement. On this basis the previous Government was not inclined to increase the superannuation guarantee rate.

Individuals are also able to make additional contributions to superannuation over and above the level mandated by the superannuation guarantee. It is estimated that around 27 percent of employees receive employer contributions (including salary sacrifice) greater than the nine percent superannuation guarantee level, while 20 percent of all employees make voluntary post-tax contributions.[162]

The adequacy of retirement incomes is typically assessed using the concept of the replacement rate, defined as the ratio of an individual's income or spending power after retirement to that before retirement. There is no specific target set for the replacement rate, however, some research has suggested that the average net replacement rate from government operated retirement income schemes in nine OECD countries is 53 percent[163].

Related to the adequacy of retirement incomes is the level of household savings. Australia's net household savings has been negative since 2002-03[164], which means that households have been borrowing to allow them to spend more on goods and services than they could afford based purely on their income. Against this measure, net household wealth has been increasing due to the housing property market, but much of this increase is in the form of unrealised gains that are often not utilised until well after retirement. Individuals retiring while still carrying significant debt (home mortgages and consumer finance) are unlikely to find their retirement incomes to be adequate. Households that are currently dis-saving while earning pre-retirement incomes will find retirement difficult.

To some extent the superannuation regime defers income into a compulsory retirement saving arrangement that might otherwise have been spent on consumption.

Several groups are likely to face greater challenges with the provision of retirement incomes including:

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[162] Australian Government, *A more flexible and adaptable retirement income system* (2004)
[163] Clare, R, Association of Super Funds of Australia (ASFA) Research Centre, *Achieving an adequate retirement income - how much is enough? Summary of research findings and issues for discussion* (October 1999)
[164] The Allen Consulting Group report to the Investment and Financial Services Association, *Australia's national saving revisited: Where do we stand now?* (August 2007)

- women, due to income relativities and furloughs from the workforce for children
- the Baby Boomer demographic approaching retirement which may not have made adequate provision or participated in the workforce
- the Generation X demographic that has a higher propensity to consume out of current income compared with past generations and
- self-employed individuals and small business owners not covered by superannuation who direct their savings into investing in their own business to fund their retirement.[165]

In assessing the adequacy of retirement income it is important to consider the impact of other measures including the various concessions and the provision of the age pension. In many cases retirees may receive a combination of superannuation payments, concessions and some component of the age pension.

Treasury's RIM Unit submitted[166] that the current policy settings will deliver substantially higher income replacement rates for senior Australians, as a group, over the longer term. The superannuation system in conjunction with the age pension is projected to provide a spending replacement rate for an individual on median earnings of 72 percent after 30 years of contributions and 77 percent after 40 years[167]. These replacement rates are conservative in that no allowance is made for superannuation contributions above the nine percent superannuation guarantee rate or for additional private savings outside of superannuation. These income replacement rates would therefore be well above the 53 percent average rate across nine OECD countries referred to above.

Unanswered questions

It is difficult to analyse the adequacy of the superannuation guarantee rate of nine percent in isolation from other retirement income support and the broader economic issues of household savings.

For Australia to meet the challenge of an ageing population, the following issues need to be addressed as part of the AFTS review:

- Is the nine percent superannuation guarantee rate sufficient? Treasury contends it is just one of the retirement income pillars, along with additional superannuation contributions and the age pension regime. Treasury modelling seems to suggest the current nine percent rate is adequate, however, there are opposing views.
- Increasing the superannuation guarantee rate implies a reduction in disposable income for individuals as additional income is deferred into a provision for retirement income. Given the low levels of household savings, would increasing the superannuation guarantee rate act to further protect individuals from the temptation of consumption spending?
- Given the negative levels of household savings, mandatory saving into superannuation is highly desirable and supports Australian capital markets with funds currently under management of about A$1 trillion. If a mandatory nine percent superannuation guarantee rate is good, potentially 12 percent would be even better, both for the retirement incomes of individuals and the Australian economy?
- Should other forms of savings, not just superannuation, be encouraged through our tax system? As noted in earlier sections of this submission, Australia's tax rates on various forms of capital income is very high in comparison with other OECD countries. This makes Australia potentially vulnerable given the increasingly mobile capital flows in the global economy.

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[165] The Allen Consulting Group report to the Investment and Financial Services Association, *Australia's national saving revisited: Where do we stand now?* (August 2007)

[166] Senate Select Committee on Superannuation, *Inquiry into Superannuation and Standards of Living in Retirement* (2002)

[167] These replacement rates are based on individuals retiring in 2032. For individuals retiring under a fully mature superannuation guarantee system in 2042, the superannuation guarantee in conjunction with the Age Pension is projected to provide a spending replacement rate of 82 percent, after 40 years of contributions.

Recommendation Section 14: The AFTS Review should assess whether the nine percent superannuation guarantee is appropriate.

In determining whether superannuation contribution levels of nine percent are sufficient to meet the challenge of an ageing population, the above questions relating to superannuation contributions and the taxation of other forms of savings should be addressed as part of the AFTS Review.

15 Climate change and tax policy alignment

The AFTS Review is being undertaken in the context of a number of emerging challenges facing Australia. In particular, the environmental challenges of the 21st century have not been appropriately addressed in the context of Australia's historical tax policy settings. For example, there is a need to consider the interrelationship of the tax system with the proposed ETS and separate tax policy consultation processes for the proposed ETS are already underway.

However, there is also a need for an overarching environmental review of the tax-transfer systems. We need to ensure that such systems (including any future changes thereto) have considered both the economic and environmental objectives of the Government in the development of tax policy. We cannot simply incorporate two existing tax Acts into one, rewrite them in plain language and assume that the job is done.

Areas where tax policy settings may need to be realigned in the context of climate change include:

- Incentives to support business investment in climate change initiatives such as carbon capture storage and low emissions technologies. This may entail a review of the capital allowances available for such technologies and any associated research and development incentives.
- The taxation treatment of new sources of energy. For example, geothermal energy is a form of renewable energy which involves the harnessing of 'hot rocks' which are discovered through drilling operations. Whilst resources exploration expenditure can qualify for an immediate income tax deduction, it is unclear whether geothermal drilling operations would qualify for an immediate deduction under the existing exploration provisions.
- The taxation treatment of new income and expense streams arising from the proposed CPRS and their interaction with other parts of the tax system. For example, new income and expenses under the proposed ETS may have adverse implications in the context of the loss recoupment rules and the same business test.
- The way the tax system influences individuals and businesses to adopt 'climate friendly' responses. For example, the taxation regime for motor vehicles, should be reviewed in light of the Government's environmental objectives.

Recommendation Section 15: An overarching review of the tax-transfer systems should be undertaken for consistency with the Government's climate change objectives.

The tax-transfer systems need to be reviewed and, where appropriate, modified so they are consistent with the Government's climate change reform agenda. The tax-transfer systems should encourage behavioural responses to embrace reform sooner rather than later.

Recommendations

List of tables and figures

Tables

Figures

Appendix A - Summary of alternate corporate tax systems

The analysis in these appendices and Section 7 reflect research undertaken in the preparation of this submission based on the theoretical expected outcomes under each system. A detailed evaluation of the alternate tax systems as implemented overseas was beyond the scope of this submission. Accordingly, this submission does not make specific recommendations for the adoption of a particular model for Australia.

System	Description
Full integration system	This system treats a company as a pass-through entity, providing full integration of the corporate tax on distributed and retained profits with the capital income taxes on the return on equity at the shareholder level. There are two variations of full integration systems. The first is the partnership or conduit version and implies that no tax is imposed on a company's profits. The company's profits are attributed to the shareholders and tax is levied at the shareholder level. Under the second version, the company remains taxable and the company's tax is then credited to the shareholders as a credit against their tax liability on the attributed profits (e.g. the full imputation system – discussed below).[168]
Full imputation system	Under a full imputation system, corporate tax is merely used as a prepayment of the tax on the return on equity at the shareholder level. Shareholders are taxed on the 'grossed up' value of the dividends but they receive a tax credit for the corporate tax already paid on the distributed profits. Tax credits are not available if the company distributes dividends but has not paid corporate taxes due to tax deductions/carried forward losses or concessions that reduce the company tax paid on the company's profits.
ACE tax system	The ACE tax system provides a deductible allowance for corporate equity in computing the company's taxable profits.[169] The ACE equals the product of shareholders' funds (generally, equals the company's total equity capital) and an imputed interest rate.
Shareholder ACE tax system	Under the shareholder ACE tax system, the deductible allowance is calculated in a similar way as under the corporate ACE tax system as noted above. However, instead of deducting the ACE from the corporate tax base, the company divides the ACE by the number of shares. Each share receives its part of the ACE and shareholders are entitled to deduct the shareholder ACE from the equity income tax base at the shareholder level.
ASE tax system	The ASE tax system introduces a deductible allowance for the normal return on equity at the shareholder level. This ASE equals the value of the company's equity, for instance, the value of the company's shares, multiplied by an imputed return as, for instance, the after-tax interest rate on medium term government bonds. The ASE tax system prevents the double taxation of the normal return on equity by providing tax relief for the normal return on equity, not at the corporate level as under the ACE tax system, but at the shareholder level.
CBIT system[170]	The CBIT system removes the deductibility of interest from taxable income. The CBIT system results in tax being levied on all corporate income, whether the source of finance is debt or equity. Interest receipts, dividends and capital gains are not taxed at the shareholder level. Under the CBIT system, there is no need for integration of corporate and shareholder level taxes.
Flat tax system	A flat tax system[171] has the following features: - The flat tax system has a single rate. - Elimination of special preferences or concessions in the tax legislation that create tax advantages for certain behaviours and activities. - No double taxation. Flat tax proposals are based on the principle that income should only be taxed once. - Territorial taxation. The flat tax is based on territorial taxation meaning that a government only taxes income earned inside national borders.

[168] Cooper, G and Gordon, R, 'Taxation of Enterprises and Their Owners', *Tax Law Design and Drafting*, Volume 2, Chapter 19, International Monetary Fund (1998)
The partnership or conduit approach was considered in the Australian Treasury, *Reform of the Australian tax system: draft white paper*, Chapter 17 (1985), which suggested "the ideal arrangement...would recognise for income tax purposes the shareholder's interest in both the distributed and undistributed earnings of the company and would tax the combined amount at each shareholder's marginal tax rate; the company would be taxed only as a withholding arrangement to collect personal tax on the income."

[169] The alternative way to address this would be to disallow interest deductibility, a solution which is commonly called 'comprehensive business income tax' and was suggested in US Department of Treasury (1992). *Allowance for Corporate Equity in Practice*, CESifo Economic Studies, Vol. 53, 2/20007, 229-262, Klemm (June 2007)

[170] The CBIT was developed by the US Department of Treasury at the beginning of the 1990s whereas the ACE was elaborated by the IFS Capital Taxes Group (1991) at the same time. Refer to Radulescu and Stimmerlmayr, *ACE vs. CBIT: Which is better for investment and welfare?*, CESIfo Working Paper No. 1850 (November 2006)

System	Description
Dual income tax system	The dual income tax combines a low flat tax rate on capital income with a progressive tax on labour income. Capital income is subject to a lower rate of tax than labour income.[172]
CCFT system	In its simplest form, under a CCFT system, income is taxed only when cash is received and costs are deductible immediately when purchases are made. A cash flow tax applies to the sales of goods and services net of purchases, including an immediate deduction for all capital expenditure. No deduction for interest expense is provided. Rather, the immediate deduction of capital expenditures provides a tax benefit equivalent to interest deductibility and also provides an equivalent deduction for equity. More complicated cash-flow tax variants adjust for, or rely on, certain cash-flows associated with financial assets and liabilities.
Classical corporate tax system	The company and its shareholders are taxed as separate entities with no allowance given to shareholders, when assessed on dividend income, for tax paid at the company level.

[171] A pure flat tax system is based on the proposal put forward by Robert Hall and Alvin Rabushka of Stanford University's Hoover Institution. Hall and Rabushka brought the concept of the flat tax to international attention in a 1981 Wall Street Journal article and later in a 1983 book, Robert Hall and Alvin Rabushka, the Flat Tax, 2nd ed (which has been subsequently updated).
[172] Taxes on capital income include company tax, taxes on individual capital income (interest, dividends, capital gains and some business income), the PRRT, crude oil excise and taxes on property such as land taxes and stamp duties on conveyances. Australian Treasury, *Architecture of Australia's tax and transfer system*, Section 6.1 (August 2008)

System	Advantages
Full integration system	Prevents double taxation (as opposed to a classical system that taxes companies and shareholders separately, which creates both equity and efficiency problems).
Full imputation system	Generally, an equitable system because capital income is taxed at the same effective rate irrespective of how it is received (as interest payments, dividends or capital gains). In a domestic setting, this system eliminates the double taxation of corporate income distributed as dividends to resident shareholders, which reduces the bias towards debt financing. Allows the government to tax capital income at progressive personal income tax rates.
ACE tax system	Promotes domestic investment. The ACE tax system ensures neutrality for financing choices. Companies will be indifferent between debt and equity finance at least regarding the corporate tax implications. Financial neutrality is only guaranteed under the ACE tax system if the imputed rate of return on equity capital equals the interest rate paid on debt[173]. Symmetric treatment of debt and equity may mitigate the need for thin capitalisation rules (since companies get a deduction for an imputed interest on equity as well as for the interest on debt). Multinationals have no incentive to undercapitalise a subsidiary operating in a country with an ACE system. The symmetric treatment may also solve the increasingly difficult problem of distinguishing between debt and equity for tax purposes.[174]
Shareholder ACE tax system	To mitigate the concern the normal return on equity could be deferred indefinitely, the shareholder ACE tax system acts as a withholding tax for capital income on the normal return on equity at the shareholder level. At the domestic level, neutrality between debt and equity is achieved if the capital income tax rate on interest payments at the personal level equals the corporate income tax rate. If foreign investors can benefit from the ACE, the shareholder ACE tax system have the same efficiency properties in an open economy as the corporate ACE tax system.
ASE tax system	The ASE tax system is tax neutral with respect of investment decisions and prevents any significant gains from income shifting by corporate owner managers.[175] If the imputed interest rate that is applied to calculate the ASE equals the interest rate paid as a reward for the debt and if the corporate tax rate equals the personal income tax rate on interest payments, the company will be indifferent between debt and equity as source of finance in a domestic setting.

[173] Refer to Radulescu and Stimmerlmayr, ACE vs. CBIT: Which is better for investment and welfare?, CESIfo Working Paper No. 1850 (November 2006)
[174] The ACE tax system might be designed to implement neutrality between debt and equity at the corporate level. However, if the tax rates at the personal level are considered as well, equity may become a more preferred source of finance than debt in the absence of a capital gains tax or if capital gains are taxed at the personal level at a lower effective rate) than dividends and interest payments. Griffith, R, Hines, J and Sorensen, P, *International Capital Taxation - Chapter prepared for Reforming the Tax System for the 21st Century: The Mirrlees Review* (March 2008)
[175] Although Norway recognised the ASE stax ystem will not significantly affect the cost of equity finance for widely held companies whose shares are traded internationally, it felt that the allowance is needed to avoid distortions to the cost of equity finance for SMEs without access to the international stock market. Sorensen, P, *Neutral Taxation of Shareholder Income*, International Tax and Public Finance, 12 pp 777-801 (2005)

System	Advantages
CBIT system	A CBIT system broadens the tax base, allowing a reduction in the corporate tax rate. Considering taxes at the corporate level, companies would no longer face a tax-induced incentive to finance their investment with debt instead of equity. Thin capitalisation rules might therefore no longer be required because domestic business tax revenue is less vulnerable to international profit shifting through transfer pricing and thin capitalisation.
Flat tax system	If the flat tax system has a low-rate flat tax, it may be an effective way of improving tax compliance, as the incentive to evade is reduced when the tax rate is less punitive. A low flat rate reduces penalties against productive behaviour, such as work, risk taking and entrepreneurship. A flat tax eliminates provisions of the tax code that create tax advantages for certain behaviour and activities. Removing deductions, credits, exemptions and other loopholes promotes growth by allowing a low tax rate and by removing incentives to misallocate resources merely to reduce a tax liability. Removing 'worldwide taxation' simplifies the tax system, promotes international comity, and enables taxpayers and companies to compete on a level playing field around the world.[176]
Dual income tax system	As capital becomes increasingly mobile across borders, there is a growing risk that a high domestic capital income tax rate will encourage taxpayers to move their wealth abroad. Separating the capital income tax rate from the labour income tax schedule allows policy makers to reduce the former to minimise the risk of capital flight (particularly, in relation to mobile capital such as interest, and possibly more mobile individuals such as expatriates). **Inflation** - The personal income tax is typically levied on the full nominal return to capital, including the inflation premium which just compensates for the erosion of the real value of nominal assets. Thus, capital income owners would be overtaxed if they were taxed at the high top marginal rate applying to labour income. Applying a low flat tax rate to capital income is a pragmatic way of dealing with this problem.[177] **Levelling the playing field** - Capital income accrues in many forms. Some of these are hard to tax for practical or political reasons. Lowering the tax rate on these types of capital income that can be taxed serves to reduce the distortions that arise when certain types of capital income cannot be included in the tax base. A low tax rate makes it easier to include realised capital gains in the tax base without discouraging and distorting asset trades too much. **Tax arbitrage** - Aligning the corporate with the personal tax rate on capital income and equalising marginal capital income tax rates across taxpayers eliminates the scope for those tax arbitrage activities that seek to exploit such differences in tax rates. **Double taxation of saving** – By taxing the return to saving, a conventional income tax tends to discriminate against those taxpayers who save a relatively large part of their lifetime income in the early stages of their life cycle. Reducing the capital income tax rate alleviates this discrimination.
CCFT system	The current corporate income tax systems in many OECD countries are based on complex accrual accounting rules, thus increasing the complexity of a tax system and leading to tax avoidance and evasion. A CCFT (based on cash flow accounting rules) might be a preferred alternative to a corporate income tax from a simplicity perspective.
Classical corporate tax system	Potentially funds a reduction of the corporate tax rate because tax is being levied on corporate profits twice (i.e. at both the corporate and shareholder level) and a tax credit is not given to the shareholder for corporate taxes paid.

[176] Daniel, M.J, 'The Global Flat Tax Revolution: Lessons for Policy Makers', *Tax Notes International* Vol 49, No. 13 1035 (February 2008)
[177] Sorensen, P, *EPRU Working Paper Series 2005-10, Dual Income Taxation: Why and How?* Economic Policy Research Unit, University of Copenhagen (2005)

System	Disadvantages
Full integration system	A full integration system could result in a large revenue loss on company profits attributed to foreign shareholders, tax-exempt bodies and low-rate taxpayers.[178] Shareholders cannot complete their tax returns until the company had provided a basis for allocating shares of profits and tax attributed to each shareholder. If the company's final attribution calculations differed from its initial calculation, either there would have to be an amendment of large numbers of personal assessments of shareholders or the amount of the amendment would have to be added (or deducted from) the tax allocated in the following year. Allocation of undistributed profits poses problems where there are two or more classes of shares with different rights to income.[179]
Full imputation system	Certain investors place greater value on imputation credits than others (e.g. domestic shareholders place greater value on imputation credits than foreign residents). There is a need for anti-dividend streaming rules which increases complexity in the tax law. Greater distortions may arise if capital gains are only taxed when they are realised or if countries do not levy a capital gains tax at all. Equity might become a more preferred source of finance than debt. If the home country of a foreign investor does not give a tax credit for corporate taxes already paid in the host country, foreign investment in the host country may be discouraged. The tax treatment of resident and foreign shareholders would be non-neutral and potentially distort investment decisions e.g. the amount of FDI.[180] That is, a full imputation system results in a higher cost of capital for foreign investors because the imputation credit is only available to resident investors.[181] However, it is arguable that this disadvantage arises because of the foreign investors' home country tax regime not because of the imputation system
ACE tax system	The ACE tax system may be seen as eroding the corporate income tax base.[182] Because of the narrower tax base, a higher tax rate needs to be set if the same amount of revenue is to be collected. If many shares in the domestic company are owned by tax-exempt institutional investors and by foreigners, the ACE tax system could result in a loss to the revenue than an allowance granted only to domestic shareholders. There may be doubts as to whether other countries will accept corporate tax payments under an ACE tax system as a basis for double tax relief.[183] The implementation of such a tax system poses some difficulties since a large amount of information is required about which interest rate should be imputed.[184]

[178] At the time the full integration system was considered in 1985 in *Reform of the Australian tax system, Draft White Paper* (June 1985), the only tax collected by Australia on that income would be the dividend withholding tax, at a rate of 15 percent when a double tax treaty is operative, compared to 54.1 percent overall take which full distribution produced at the time.

[179] It was for these reasons the Australian Government decided in 1985 that full integration was not feasible at that time (para 17.16 of *Reform of the Australian tax system, Draft White Paper* (June 1985))

[180] Globalisation has meant that large corporations can raise their capital internationally and do not have to rely on domestic shareholders for equity finance. Foreign-owned companies might face a tax-induced incentive to excessively finance investment with debt.

[181] However, this effect might be mitigated if the full imputation system would be combined with an ACE tax system. OECD, *OECD Tax Policy Studies No.16, Fundamental Reform of Corporate Income Tax*, Part IV Chapter 9 (2007)

[182] Griffith, R, Hines, J and Sorensen, P, I*nternational Capital Taxation - Chapter prepared for Reforming the Tax System for the 21st Century: The Mirrlees Review* (March 2008)

[183] Klemm, A, 'Allowance for Corporate Equity in Practice', *CESIfo Economic Studies Vol. 53 2/2007*, pp 229-262 (June 2007)

[184] Radulescu, D and Stimmerlmayr, M, *CESIfo Working Paper No. 1850, ACE vs. CBIT: Which is better for investment and welfare?* (November 2006)

System	Disadvantages
Shareholder ACE tax system	Equity with the shareholder ACE tax system may not be achieved as foreign investors might not necessarily be able to benefit from the full allowance/credit if it would be allowed only against withholding taxes. Similar to the ACE tax system, it has been argued that tax rates such as the corporate tax rate may need to be raised to implement the new system. The raising of the corporate tax rate might have a negative impact on the location decision of companies, on the amount of FDI and might encourage a company to shift 'economic rents' out of the country. Given an international environment where countries compete over corporate tax rates, the required equality between personal level tax on interest payments and the corporate tax rate under the shareholder ACE might limit the revenue that can be raised through the taxation of interest income.
ASE tax system	The debt/equity distortions continue to exist at the corporate level (thus, there continues to be a need to retain thin capitalisation rules). The ASE tax system is neutral with respect to the debt/equity choice only for domestic investors. Because the normal return on equity is no longer taxed at the shareholder level, tax revenues will decline. To compensate the loss in revenue, a government might consider increasing the corporate tax rate. A rate increase might have a negative impact on the domestic amount of corporate investment, on the international location decision of a company, on the amount of FDI and might encourage a company to shift the 'economic rents' out of the country.[185] The ASE tax system puts tax revenues further under pressure because the corporate income tax rate has to be equal to the personal income tax rate levied on interest payments. The ASE tax system is calculated on the basis of the value of the company's shares. The tax revenue that governments will raise might be more volatile compared to the revenue raised under the ACE tax system, which uses the company's book value of equity to calculate the ACE allowance. Shareholder income tax is neutral with respect to investment and financing decisions and with respect to decisions to realise a capital gain or loss provided full loss offsets are granted. However, administrative considerations and the need to constrain tax avoidance are likely to necessitate some limitations on loss offsets. In practice, it may be difficult to achieve full neutrality of the shareholder income tax.
CBIT system	There would be transitional issues in moving to CBIT e.g. companies relying heavily on debt would be significantly disadvantaged by such a reform. Any such reform would therefore have to be phased in slowly to give a company time to adjust its financial position.[186]
Flat tax system	It is commonly claimed that a flat tax is politically unacceptable because it is regressive. In simple terms, it imposes a greater burden (relative to resources) on those with lesser ability to pay. It is argued that switching to a flat tax would involve increasing taxes to the lowest earners while reducing them for the highest. Furthermore, critics state that given that more than 64 percent of income tax revenue comes from the top 25 percent of taxpayers in Australia, the costs to government of transitional arrangements to make this more acceptable would be considerable. These would include encouraging employers of lower wage earners to increase gross remuneration levels to maintain after tax wages, while reducing those of the highest earners to keep take home pay close to constant. Given differences in the wage and salary profiles of each business, the costs to industry would vary significantly, with risks of socially unacceptable price increases and/or layoffs in many areas.[187]

[185] The loss in revenue might be smaller than under the ACE tax system as the corporate income tax under the ASE tax system continues to be levied on the normal return on foreign owned equity financed investment, which escapes taxation under the ACE tax system.
[186] In fact, the US Treasury (1992) suggested phasing in the CBIT over a period of about 10 years.
[187] Chipman, L, CIS Policy Monograph 66, *The Very Idea of a Flat Tax, Perspectives on Tax Reform (6)*, The Centre for Independent Studies (2004)

System	Disadvantages
Dual income tax system	A dual income tax system requires that income be split into a labour income component and a capital income component. Businesses may find this practically difficult and an administrative challenge. There may be an incentive to shift income from labour to capital if capital income is taxed at a much lower (marginal) rate than labour income. Thus, anti-avoidance requirements may be needed.
CCFT system	A CCFT system will require major adjustments for corporates and tax authorities compared with a corporate income type of tax reform. The CCFT system automatically creates a bias between reinvestment and distribution of corporate profits. The system may only be suitable for countries with low levels of corporate tax revenue. A cash flow type tax may not qualify as an income tax and is likely to require renegotiations of tax treaties.
Classical corporate tax system	Creates equity issues as there is double taxation on income derived by a company and distributed to shareholders.

Appendix B – Case studies of alternate corporate tax systems

The analysis in these appendices and Section 7 reflect research undertaken in the preparation of this submission based on the theoretical expected outcomes under each system. A detailed evaluation of the alternate tax systems as implemented overseas was beyond the scope of this submission. Accordingly, this submission does not make specific recommendations for the adoption of a particular model for Australia.

System	Country
Full integration system	Research undertaken to date provides no evidence of adoption.[188]
Full imputation system	Australia
ACE tax system	Austria, Croatia, Italy, Brazil and Belgium
Shareholder ACE tax system	Research undertaken to date provides no evidence of adoption.
ASE tax system	Norway
CBIT system	This model was proposed by the US Treasury in 1992. No country has introduced such a system[189], although Denmark and Germany have moved towards such a system by curtailing interest deductibility[190]. The President's Advisory Panel on Tax Reform (2005) put forward in the US a proposal for the taxation of large businesses. It proposed a profit tax of 30 percent and the abolition of debt interest deductibility.[191]
Flat tax system	24 jurisdictions now have a flat tax regime[192]: Jersey 1940; Hong Kong 1947; Guernsey 1960; Jamaica 1986 Estonia 1994; Latvia 1995; Lithuania 1996; Russia 2001 Slovakia 2004; Ukraine 2004; Iraq 2004; Romania 2005 Georgia 2005; Pridnestrovie 2006; Iceland 2007; Mongolia 2007 Krygyzstan 2007; Macedonia 2007; Montenegro 2007; Mauritius 2007 Kazakhstan 2007; Albania 2008; Czech Republic 2008; Bulgaria 2008
Dual income tax system	The Nordic countries generally apply a dual income tax system for certain enterprises. Finland, Norway an Sweden all have special tax rules for the owners of closely held companies.

188 It was for these reasons the Australian Government decided in 1985 that full integration was not feasible at that time (para 17.16 of *Reform of the Australian tax system, Draft White Paper* (June 1985))
189 Warburton, D and Hendy, P, *International Comparison of Australia's Taxes*, Chapter 5.5 (2006)
190 In Germany, for instance, deductible interest is now limited (above some minimum amount) to 30 percent of taxable earnings before interest, taxes and depreciation. Keen and Luzio, 'France, Reviewing the Tax System', *Tax Notes International*, Vol 50, No. 13 (30 June 2008)
191 The present US tax code allows for debt interest deductibility and there are 8 tax brackets the lowest of 15 percent and the highest of 39 percent which apply to large businesses (The President's Advisory Panel on Tax Reform 2005).
192 Daniel, M.J, 'The Global Flat Tax Revolution: Lessons for Policy Makers', *Tax Notes International*, Vol 49, No. 13 1035 (February 2008)

System	Country
CCFT system	UK - North Sea Fiscal Regime Norway - the petroleum tax system Italy - the regional tax on business activities Estonia - CCFT Australia - PRRT
Classical corporate tax system	Australia pre-imputation (1987)

<table>
<tr><th>System</th><th colspan="2">How it works</th></tr>
<tr><td>Full integration system</td><td colspan="2">Research undertaken to date provides no evidence of adoption.</td></tr>
<tr><td>Full imputation system</td><td>
<table>
<tr><td>Company profits</td><td></td><td>$100</td></tr>
<tr><td>Company tax 30%</td><td></td><td>($30)</td></tr>
<tr><td>After tax</td><td></td><td>$70</td></tr>
<tr><td>Shareholder dividend</td><td></td><td>$70</td></tr>
<tr><td>Franking Credit Gross Up</td><td></td><td>$30</td></tr>
<tr><td></td><td>=</td><td>$100</td></tr>
<tr><td>Tax*</td><td></td><td>$30</td></tr>
<tr><td>Franking Credit</td><td></td><td>($30)</td></tr>
<tr><td>Net tax</td><td>=</td><td>$0</td></tr>
</table>
</td><td>Applies to dividends paid by Australian resident corporate entities to Australian resident shareholders.

Provides credit relief at the shareholder level.

Australian companies receive franking credits for Australian corporate tax paid.

These corporate taxes paid are then allocated to shareholders by attaching the franking credits to distributed dividends.

Resident shareholders are taxed on the ‘grossed up’ value of dividends (dividends plus franked credits) but are entitled to a tax offset equal to franking credits.

The imputation credits are fully refundable (i.e. taxes will actually be paid back if the imputation credits exceed the shareholder taxes due).

In a domestic setting, this system eliminates the double taxation of corporate income distributed as dividends to resident shareholders, which reduces the bias towards debt financing.

For Australian tax purposes non-resident shareholders cannot use the franking credits for Australian tax paid. Franked dividends are taxed at the Australian corporate tax rate and they might be taxed again in the shareholder’s country of residence.

*This example assumes the shareholder’s tax on the dividend is 30 percent.</td></tr>
<tr><td>ACE tax system</td><td colspan="2">Brazil
- Known as ‘remuneration of equity’.
- System implemented in 1996.
- Applies to the book value of the company’s entire equity stock. The rate is the rate applicable to long-term loans.
- The ACE can be deducted only if the return is distributed to shareholders.
- Up to the level of the ACE, dividends can be paid as ‘interest on equity’; a 15 percent (personal level) withholding tax will be levied, which also applies to interest payments.
- Retained earnings and distributed earnings in excess of the ACE are taxed at the corporate tax rate.

Belgium
- Known as ‘risk capital deduction/notional interest deduction’.
- Introduced from 1 January 2006.
- The notional return is deductible.
- The notional return is calculated based on the book value of equity and an average monthly government bond rate of the year preceding the fiscal year by two years. The rate is capped at 6.5 percent and cannot change by more than one percentage point (pp) from year to year. A special SME rate is 0.5pp higher.

Austria
- Known as ‘notional interest’.
- Operational from 2000 to 2004.</td></tr>
</table>

System	How it works
	- Applied only to book value of new equity. - Imputed return was taxed at a reduced corporate tax rate of 25 percent instead of the statutory rate of 34 percent. - From 2005, Austria reduced its corporate tax rate to 25 percent for all profits and investments and the ACE tax system was abandoned. **Italy** - Known as 'dual income tax.'[193] - Implemented a (partial) ACE tax system from 1997 to 2003. - Applied to the book value of new equity only. 120 percent of the book value was used to calculate the ACE in 2000 and 140 percent in 2001; it was 100 percent in other years. - Imputed interest rate was seven percent from 1997 until 2000; six percent afterwards. - The main feature of the Italian ACE system was that the imputed return was taxed at a reduced corporate tax rate of 19 percent instead of the statutory 37 percent rate (36 percent in 2001-02, 34 percent in 2003). - From 2004, Italy reduced its corporate tax rate to 33 percent for all profits and investments. **Croatia** - Known as 'protective interest'. - Implemented full ACE tax system from 1994 to the beginning of 2001. - Return of five percent plus the inflation rate of industrial goods (if positive) could be imputed to the book value of the firm's equity stock. - The ACE was fully deductible from the corporate tax base. - The statutory corporate tax rate that applied only to economic rents was 35 percent. - In 2001, the system was abolished. - The statutory corporate tax rate was reduced to 20 percent.
Shareholder ACE tax system	Research undertaken to date provides no evidence of adoption.
ASE tax system	The Norwegian model imposes a personal tax on the equity premium i.e. a personal tax on returns to shares in excess of the after tax interest rate on government bonds. The equity premium is included in the shareholder's taxable capital income. The imputed return known as the 'rate of return allowance' (RRA) recently implemented as of 1 January 2006, is deducted from taxable shareholder income. The tax is levied on the realised income from shares after deduction of the RRA. The realised income from a share consists of the dividend plus any realised capital gain minus any realised capital loss. The allowance is calculated as the purchase price of the share (on the stepped up basis – sum of the original acquisition price of the share and all the RRAs on the share not utilised in the previous years) multiplied by an after tax risk free interest rate of 2.1 per cent in 2006. This rate is the yearly average of the after tax return on the interest on three month government bonds for that year. The RRA applies to the shares of Norwegian and foreign companies owned by resident taxpayers in Norway. The tax system replaces the previous imputation system. This allowance prevents the double taxation of the normal return on equity by providing tax relief for the normal return on equity, not at the corporate level as under the ACE system, but at the personal level instead. **Example** A numerical example illustrates the workings of these rules and suggests why the shareholder income tax is neutral.[194]

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[193] Italy had chosen a confusing name by calling it a 'Dual Income Tax system'. Although there is some logic to this name given there is a dual rate, with a lower rate on normal profits than on economic rents, the confusion is caused by the fact that the term 'Dual Income Tax system' has been popularised by a previous tax reform in the Nordic countries, which introduced different tax rates on income from labour and capital; Klemm, A, 'Allowance for Corporate Equity in Practice', *CESIfo Economic Studies Vol. 53 2/2007*, pp 229-262 (June 2007)

System	How it works

Year 1

1. Injection of equity at the start of the year	1000
2. Profit after corporation tax (5% of 1.)	50
3. Dividend	30
4. Retained profit (2.-3.)	20
5. RRA (5% of 1.)	50
6. Unutilised RRA (5.-3.)	20

Year 2

7. Stepped up basis of share	1020
8. Profit after corporation tax (5% of (1.+ 4.))	51
9. RRA (5% of 7.)	51
Scenario 1: Shares are realised at the end of year 2	
10. Revenue from the sale of shares at the end of year 2 (1.+4.+8.)	1071
11. Stepped up basis of share at the start of year 2 (=7.)	1020
12. RRA for year 2 (=9.)	51
13. Taxable capital gain (10.-11.-12.)	0
Scenario 2: All profits are distributed at the end of year 2	
14. Dividend at the end of year 2 (4.+ 8.)	71
15. Total RRA (6.+9.)	71
16. Taxable dividend (14.-15.)	0

Administering the shareholder income tax

The shareholder income tax requires that separate accounts be kept for each of the taxpayers' share in each company.

From the start of 2004, a shareholder register was in fact established in Norway, recording shareholdings and share values based on information reported by Norwegian companies and shareholders.

[194] Sorensen, P, *Neutral Taxation of Shareholder Income*, International Tax and Public Finance, 12 pp 777-801 (2005)

System	How it works
CBIT system	Research undertaken to date provides no evidence of adoption.
Flat tax system	**Hong Kong**[195] Hong Kong has enjoyed a flat tax since 1947. Hong Kong is known to be one of the world's fastest growing economies.[196] As of April 1, 2008, Hong Kong taxpayers are subject to a low-rate optional flat tax of 15 percent on personal income. Taxpayers can choose an alternate system with graduated rates and the top rate in this system is 17 percent. There is no withholding in Hong Kong meaning that taxpayers pay their entire income tax liability themselves (usually twice a year). The corporate tax is not perfectly aligned with the personal tax, but the flat rate is just 16.5 percent so the gap is very small. Hong Kong generally does not double tax dividends, interest and capital gains. There is no death tax or wealth tax. Hong Kong has a territorial system so there is no second layer of tax on income earned by Hong Kong citizens in other jurisdictions. There are no payroll taxes in Hong Kong. There is not a general sales tax or value-added tax in Hong Kong. The entire tax code, even after being in place for 60 years, is only about 200 pages long. **Estonia**[197] Estonia has a flat tax of 21 percent. When first implemented in 1994, the rate was 26 percent. By 2011, it is expected to drop to 18 percent. Estonia levies a corporate tax only on distributed profits (known as a 'cash flow tax'[198]). Businesses merely impose a withholding tax of 21 percent on any dividends paid to owners (whether resident or foreign resident). There is no double tax on those dividends, and interest is also free from double taxation. There is no death tax or wealth tax (which eliminates the tax bias against saving and investment). Unlike Hong Kong, Estonia does have other taxes, including an onerous 29 percent payroll tax (technically 33 percent with 4 percent going directly into personal retirement accounts). Estonia also has a value added tax of 18 percent. With a flat tax, Estonia achieved the following benefits: - Economic growth, even after adjusting for inflation, has averaged nearly nine percent over the past six years. - The country's budget has been in surplus for the past six years because revenues are rising so quickly. Personal income tax revenues have doubled since 2000 and corporate revenues have jumped by about 300 percent during the same period. - Unemployment has dropped from more than 12 percent at the beginning of the decade to about six percent today. Not all flat tax systems are created equal. For example, in the cases of Lithuania and Russia, there is a significant difference between the corporate rate (higher in Russia) and the individual rate (higher in Lithuania).

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[195] Daniel, M.J, 'The Global Flat Tax Revolution: Lessons for Policy Makers', *Tax Notes International*, Vol 49, No. 13 1035 (February 2008)
[196] World Economic Forum, *Global Competitiveness Index rankings and 2007–2008 comparisons* http://www.gcr.weforum.org/
[197] Daniel, M.J, 'The Global Flat Tax Revolution: Lessons for Policy Makers', *Tax Notes International,* Vol 49, No. 13 1035 (February 2008)
[198] OECD, *OECD Tax Policy Studies No.16, Fundamental Reform of Corporate Income Tax*, Chapter 6 (2007)

System	How it works
Dual income tax system	**Finland**[199] Until 2005, Finnish tax law required that the 'gross-up' dividends from shares in non-listed companies exceeding an imputed return to the company's net assets be taxed as labour income, with a credit being granted for the underlying company tax. Dividends below the imputed return were effectively exempt from tax at the shareholder level, as a consequence of the Finnish imputation system and the similarity of tax rates on corporate and capital income. Realised capital gains on shares were fully taxed as capital income. To reduce the tax incentive for owners of small companies to transform labour income into capital gains, Finland has thus, accepted double taxation of retained corporate earnings. From 2005, Finland abolished the imputation system. The corporate income tax rate was reduced from 29 percent to 26 percent and the withholding tax on dividends was reduced from 29 percent to 28 percent. To obtain relief from double taxation, only 70 percent of the dividend is included in the shareholder's capital income and for unlisted companies only 70 percent of the dividend above the imputed return is included in taxable labour income. Dividends from non-quoted corporates are tax exempt up to a limit of 70,000 Euros. For non-corporate shareholders, the rules for taxation of long term capital gains have been slightly tightened. **Sweden**[200] Sweden imposes progressive labour income tax on dividends above an imputed return to the net assets of closely held companies. However, this is only done for dividends accruing to 'active' shareholders. Moreover, for all shares in non-quoted companies, dividends below an imputed return to the basis of the share are exempt from capital income tax and only bear the corporate income tax burden of 28 percent, and the unutilised rate of return allowance may be added to the basis of the share. Realised capital gains on shares are generally taxed as capital income, but half of the gain on shares realised by 'active' owners is taxed as labour income up to a cap. **Norway**[201] Since the introduction of the dual income tax system in 1992, Norway has treated 'active' shareholders in much the same manner as the self-employed. However, because of the difficulties of distinguishing between active and passive shareholders, Norway introduced in 2006 a variant of the shareholder income tax. **Denmark**[202] Denmark was the first country to implement a dual income tax as early as 1987, but dividend income was never taxed at a single flat rate. Dividend income is double taxed at the corporate and the personal level, although at a reduced rate. Since 1994 dividends have been subject to a 28 percent withholding tax which is final for dividend income below the threshold and which is credited against the higher tax rate of 43 percent for dividend income above the threshold. The Danish income tax code distinguishes personal income, capital income and income from shares. But only share income is taxed at the reduced rates, whereas personal and capital income, in particular interest income, is taxed according to the progressive schedule. A separate schedule is applied to capital gains.

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199 Sorensen, P, *EPRU Working Paper Series 2005-10, Dual Income Taxation: Why and How?*' Economic Policy Research Unit, University of Copenhagen (2005)
200 Sorensen, P, *EPRU Working Paper Series 2005-10, Dual Income Taxation: Why and How?*' Economic Policy Research Unit, University of Copenhagen (2005)
201 As noted in the ASE section, under the new Norwegian rules for the taxation of income from shares, all Norwegian resident personal shareholders will become subject to tax on dividends and realised capital gains exceeding an imputed return to the stepped-up basis of their shares. Thus, the tax will apply to holders of listed and unlisted shares. The excess returns to shares will be taxed at a flat capital income tax rate which will come on top of the corporation tax on the underlying profits. Given the tax rate structure in Norway, the sum of the corporation tax and the capital income tax on the 'excess' returns to shares will correspond roughly to the top marginal tax rate on labour income. Thus, the holders of shares in closely held companies will not be able to score any significant gain by transforming labour income into shareholder income. Hence, income splitting rules for 'active' shareholders was abolished. For the purpose of administering the new shareholder income tax, the Norwegian tax authorities will rely on a centralised, computerised register of all resident Norwegian personal shareholders which will keep track of adjusted basis values of shares and of unutilised rate of return allowances. Sorensen, P, *EPRU Working Paper Series 2005-10, Dual Income Taxation: Why and How?*' Economic Policy Research Unit, University of Copenhagen (2005). Also, see Sorensen, P, 'Neutral Taxation of Shareholder Income', *International Tax and Public Finance*, 12 pp 777-801, Springer Netherlands (2005)
202 Genser, B, The Dual Income Tax: Implementation and Experience in European Countries, Andrew Young School of Policy Studies, Georgia State University (April 2006)

System	How it works
CCFT system	**UK – The North Sea Fiscal regime** There are three tiers under this regime that generally apply in relation to oil and gas production: the Petroleum Revenue Tax (which was abolished on 16 March 1993 for oil fields given development consent on or after that date); the ring fence company tax and the supplementary charge. **Norway - The petroleum tax system** Norway does not levy a genuine corporate cash-flow tax on profits from the petroleum sector. However, the generous tax depreciation allowances and the deductibility of interest payments imply that the normal return on investment in the petroleum sector is effectively tax exempt. **Italy - The regional tax on business activities** In Italy, the regional tax on business activities is levied on the value of production in each taxable period. **Estonia - CCFT** Since 2000, Estonia levies a corporate tax only on distributed profits. This distribution tax is levied on dividends and on certain other corporate expenses which could be seen as hidden dividends as, for instance, fringe benefits not subject to personal income tax and interest payments that are excessively high compared to the market conditions on similar debt obligations.[203] **Australia - PRRT** The PRRT applies to all petroleum projects in offshore areas (or Commonwealth adjacent areas) under the *Petroleum (Submerged Lands) Act 1967,* other than production licences derived from the North West Shelf exploration permits; the latter are subject to the excise and royalty regime. This legislation applies from 1 July 1987.

[203] OECD, *OECD Tax Policy Studies No.16*, *Fundamental Reform of Corporate Income Tax*, Part III Chapter 6 (2007)

System	How it works	
Classical corporate tax system	Company profits $100 Company tax 30% ($30) After tax $70 Shareholder dividend $70 Franking Credit Gross Up $0 = $70 Tax $21 Franking Credit $0 Net tax = $21	Under a classical corporate tax system, the company and the shareholder are taxed as separate entities. Unlike the full imputation system, resident shareholders are not taxed on a 'grossed up' value of the dividends and are not entitled to a franking credit for the tax paid at the company level. In this example, total tax paid in respect of the income derived by the company is $51 ($30 at the company level and $21 at the shareholder level on receipt of the dividend). This example assumes the shareholder's tax on the dividend is 30 percent.

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