5. Investment and entity taxation

Globalisation carries profound implications for Australia's tax system and for the taxation of investment in particular. In a world of increased capital mobility, company income tax and other taxes on investment have a major impact on decisions by businesses on where to invest, how much and what they invest in and where to declare their profits.

Australia has been successful over recent decades in attracting foreign capital to finance relatively high levels of domestic investment. While the continuing growth of China and India, and the consequent strength in Australia's terms of trade, should ensure continued strong investment in Australia's resource sector, attracting investment in other sectors may become more challenging.

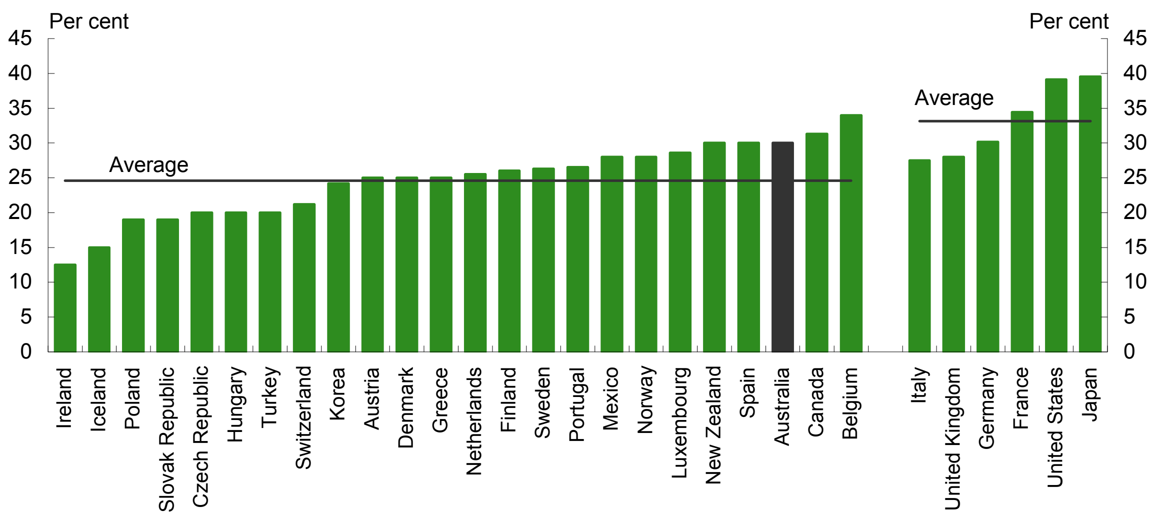
In the future it will be important to ensure that Australia remains an attractive place to invest in, and that investment is directed towards its most productive uses. In the long term, a larger and more productive capital stock will not only result in higher growth but is also likely to result in higher wages.

5.1 Reducing tax on business investment

A lower company income tax rate

Relative to other similar size OECD countries, Australia's company income tax rate is high. In 2009, Australia's company tax rate of 30 per cent was around 5 percentage points higher than the average for small to medium size OECD economies and was third highest behind Belgium, which has a significantly narrower company tax base, and Canada, which is moving to a lower rate (see Chart 5.1).

Chart 5.1: Statutory corporate tax rates, OECD countries 2009



Source: OECD (2009d).

Australia should respond to these developments by reducing the company income tax rate to 25 per cent over the short to medium term, as fiscal and economic circumstances permit. This would ensure that Australia remains an attractive place to invest — not only in the resources sector but also in the non-resource sectors of the economy.

Given company income tax also acts as a tax on profits derived from Australia's non-renewable resources, improved arrangements for charging for the use of these resources should be introduced at the same time. A broad-based resource rent tax would be a more effective way to ensure an appropriate return to Australians for the exploitation of their natural resources (see Section 6.1).

Reducing taxes on investment, particularly company income tax, would also encourage innovation and entrepreneurial activity. Such reforms would increase income for Australians by building a larger and more productive capital stock, and by generating technology and knowledge spillovers that boost the productivity of Australian businesses. A lower company income tax rate would also reduce incentives for foreign multinationals to shift profits out of Australia.

Improving resource allocation

Continuing to reduce biases in favour of particular assets or activities by aiming for a broader, more uniform company income tax base would ensure that investment is targeted to its most productive uses. Reducing biases against risk-taking would also encourage entrepreneurial activity, which is important for economic growth.

Aside from inherent difficulties in measuring economic income, features of the current system may bias investment and other business choices towards less productive outcomes. In turn, this may reduce productivity and economic growth.

Table 5.1: Effective tax rates by industry, selected countries (domestic)

	Australia	Canada	Japan	United Kingdom	United States
All industries	24	24	39	26	26
Construction	23		36	21	25
Financials	27	13	36	26	15
Information	14	19	35	21	19
Manufacturing	25	24	38	25	28
Mining	17	17			22
Other	24	23	41	26	30
Professional	19		36	24	21
Real estate	23		40	26	24
Retail trade	27		44	27	34
Transportation	22		39	25	24

Source: Markle & Shackelford (2009), Table 4.

Some of the biases from existing arrangements arise from current capital allowance arrangements, which favour some assets over others. Existing concessional arrangements should be reconsidered, including those relating to statutory effective life caps, capital works (including buildings), exploration expenses and the taxation of agriculture and forestry more generally.

Capital allowance arrangements could be improved by enhancing and streamlining the capital allowance arrangements. The existing low-value pool should be abolished, and instead all assets with a value of less than $1,000 should be immediately deductible for all taxpayers — apart from those eligible for the small business concessions, who can already write off assets with a value of less than $1,000 and for whom an increase in this threshold is recommended (see 'Simplifying arrangements for small business' below). This would reduce record keeping requirements, removing the need to maintain a low-value pool.

Another bias in current company tax arrangements relates to the asymmetric treatment of gains and losses. To improve current loss arrangements, companies should be allowed to carry-back and offset a revenue loss against a prior year's taxable income, with the amount of any refund limited to the company's franking account balance. Allowing the carry-back of losses would also improve the automatic fiscal stabilisers.

To reduce biases in how foreign debt is accessed, interest withholding tax on interest paid by financial institutions operating in Australia should generally be removed. In addition, consideration could be given to removing interest withholding tax in future tax treaty negotiations, providing there are appropriate safeguards to limit tax avoidance.

Taxation arrangements applying to Australian managed funds and related services should also be improved to provide greater certainty that foreign savings managed by Australian businesses and invested offshore will not be subject to Australian tax.

Simplifying arrangements for small business

Small businesses bear a disproportionally higher share of the tax compliance burden. To reduce this burden and to provide small business with greater tax certainty, the existing small business tax concessions should be streamlined and broadened. Access to the small business tax concessions under the small business framework should be extended by increasing the 'small business entity test' (turnover test) from $2 million to $5 million.

In addition, the threshold for determining a low-value asset for small businesses should be increased to $10,000. This would allow small businesses to immediately write off most of their asset purchases, simplifying and providing more certain arrangements while also providing cash flow benefits.

Arrangements for small business should be simplified further by allowing any remaining depreciating assets (other than buildings) that are not immediately written-off to be grouped in a single pool (rather than the two existing pools), with the entire pool written off at a single declining balance rate.

Combined with streamlining and rationalising the small business capital gains tax concessions (see Section 4.2), and the Standard Business Reporting program (see Section 10.3), these measures will result in significant simplification for small businesses.

5.2 The treatment of business entities and their owners

A key issue for the review has been whether Australia should continue with dividend imputation as the means of integrating the taxation of companies and shareholders. Globally there has been a trend away from dividend imputation, leaving Australia and New Zealand as the only two OECD economies with imputation systems.

Dividend imputation continues to provide benefits such as neutrality around financing and entity choices. It also enhances the integrity of the tax system by reducing the benefits of minimising company income tax. These benefits mean that dividend imputation should be maintained in the short to medium term.

However, as the Australian economy has become more open, the benefits of dividend imputation have declined. Accordingly, if the trend of increased international openness and integration with international capital markets continues, alternatives to dividend imputation should be considered.

Such alternatives could include switching double tax relief from the shareholder to the company. One option would be a shift to a partial integration system, with the company income tax rate reduced at the same time as more limited relief is provided to dividends. Moving to a company or business level expenditure tax (see Section 5.3) would be another, more far-reaching option.

While imputation is maintained, imputation credits should continue to be provided only for Australian company income tax paid, and existing prohibitions on dividend streaming and franking credit trading practices should be maintained. Moving away from these positions would compromise the integration function and integrity benefits of dividend imputation for little gain.

As Australia's dividend imputation system affects the allocation of investment between Australia and other countries, mutual recognition of imputation credits between Australia and New Zealand has been raised in the context of developing closer economic relations. To further economic integration, consideration could be given to the appropriate degree of harmonisation of business income tax arrangements between the two countries, with bilateral mutual recognition only one element of this broad consideration.

In contrast to companies, partnerships and trusts are typically taxed on a flow-through basis. This treatment remains broadly appropriate. However, the rules that set out how trusts are taxed are complex and give rise to uncertainty and should be updated and re-written.

5.3 A company income tax system for the future

The increasing globalisation of the Australian economy raises questions about the long-term appropriateness of the existing company income tax system and the dividend imputation system.

Australia, in the future, should consider moving the company income tax system towards a business level expenditure tax, such as an allowance for corporate equity, subject to further international development of tax models.[7] A business level expenditure tax would reduce source-based taxes on the normal return to investment in Australia, provide greater neutrality between debt and equity and reduce tax biases across different investments, improving the stability and productivity of domestic business and investment. It may also provide opportunities for wide-ranging simplification of the company income tax system.

7 The case for these systems was outlined for the Review in the Australia's Future Tax System Conference Papers (Sørensen and Johnson 2010 & Auerbach 2010).

Such a system would provide a more effective mechanism for company and personal tax integration in a world of increased capital mobility.

However, in contemplating the replacement of company income tax with an expenditure tax, a significant concern for the Review is that there has been limited or no practical use of such taxes for this purpose. Replacing the current company income tax system with one of these alternatives would therefore involve considerable risks. For example, the practical implications from a tax administration and compliance perspective are unknown. There may also be opportunities for tax arbitrage if Australia is one of only a few countries using such a system.

In light of the potential benefits of business level expenditure taxes, there is likely to be increased interest internationally in them as replacements for company income taxes. Such a system may suit Australia and is worthy of further consideration and public debate. It is possible that other economies will move towards such systems over coming years and it could be in Australia's interest to join this trend at an early stage. An example of a blueprint for the reform of Australia's company income tax system, based on the allowance for corporate equity, is presented in Sørensen and Johnson (2009).

Moving to a business level expenditure tax could be complemented with improved taxation of savings income. This could include moving to a broader-based dual income tax that includes dividends and greater use of accrual recognition or deeming to measure savings income. Such a move could provide a more equitable and efficient basis for the taxation of savings, and be designed to reduce income conversion problems.

5.4 Not-for-profit organisations

Reflecting their highly valued contribution to community welfare, not-for-profit (NFP) organisations receive government and community support for their philanthropic activities.

Tax concessions and regulatory arrangements

Tax concessions are an important and longstanding source of funding for the NFP sector (see Table 5.2). However, the system of concessions is complex and does not appropriately reflect current community values about the merit and social worth of activities. The complexity of these concessions is exacerbated by the opaque and inconsistent regulatory arrangements for the NFP sector.

Consistent with the recommendations of previous inquiries, these issues could be addressed through the establishment of a national charities commission to monitor, regulate and provide advice to all NFP organisations. The commission could be tasked with streamlining the NFP tax concessions, and modernising and codifying the definition of a charity.

Table 5.2: Main tax concessions for major types of NFP organisations[a]

	Value ($m) (2008–09)	Charities	Public benevolent institutions(b) and health promotion charities	Deductible gift recipients	NFP and public hospitals, and public ambulance services
Income tax exemption(c)(d)	*	Yes	Yes	-	Yes
GST concessions	*	Yes	Yes	Yes	Charities only
FBT exemption ($17,000)	260	-	-	-	Yes
FBT exemption ($30,000)	715	-	Yes	-	-
FBT rebate(e)	20	Charitable institutions only	-	-	-
Deductible gifts	1,080	-	Yes	Yes	Yes

(a) Entities may have more than one status (for example, a charity could also be a deductible gift recipient).
(b) There are over 11,000 public benevolent institutions in Australia, including organisations such as: Anglicare Australia Inc; Australian Federation of Disability Organisations Ltd; Australian Red Cross Society; Parents, Families and Friends of Lesbians and Gays Inc; Refugee Council of Australia Inc; and Society of St Vincent de Paul Pty Ltd.
(c) Many NFP organisations are taxable, but are entitled to special rules for calculating taxable income and lodging income tax returns and are able to access special rates of tax.
(d) Income tax exempt entities that do not meet the broad definition of a NFP organisation, such as municipal corporations, local governing bodies, constitutionally protected funds, and public authorities constituted under Australian law, are not discussed in this section.
(e) Certain non-government NFP organisations are eligible for this concession.
* The value of the concession cannot be quantified.
Source: ATO (2007) and Treasury (2009).

Commercial activities

The High Court of Australia's 2008 decision in the Word Investment case has significantly increased the scope of NFP organisations to undertake commercial activities. In light of this decision, the Review has considered the impact of the three main tax concessions (income tax, GST and FBT) on competitive neutrality.

While the income tax and GST concessions do not appear to violate this principle, the FBT concessions provide recipient organisations with a competitive advantage in labour markets, as they enable them to pay the market wage at a lower cost. This distortion is particularly problematic in relation to hospitals, where nursing shortages are an ongoing concern.

The FBT concessions should be removed and replaced with direct government funding. All NFP organisations eligible for tax concessions should be eligible to apply for funding for specific projects, or to assist with the costs of recruiting specialist staff. Reflecting the importance the concessions in helping existing recipients to deliver their services, the concessions should be reconfigured over 10 years to provide them with sufficient time to adjust the prices they charge for their services, and to renegotiate employment contracts and funding models.

Mutuality

Where NFP clubs operate large trading activities in the fields of gaming, catering, entertainment and hospitality, the rationale for exempting receipts from these activities from income tax on the basis of a direct connection with members is weakened. Simple, efficient and concessional tax arrangements should be established for clubs with large trading activities in these fields. One option is to apply a concessional rate of tax to total net income from these activities above a high threshold.