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Tax White Paper Task Force
The Treasury
Langton Street
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This is a submission on the taxation of corporations and equity (share) holders confined to issues covered by Discussion Questions 24 and 25 in Chapter 5: General business tax issues in the Discussion Paper (DP).

I do not represent any interest group and my views are personal.

My answers to the questions are:

24. How important is Australia's corporate tax rate in attracting foreign investment?

> **The statutory rate is not a determining factor in committing to an Australian investment. Australia can target foreign investment by (1) extolling its natural competitive advantages and (2) creating advantages as has been done by other countries in marketing and banking hubs, and tax-free zones; whether these are of benefit to economic growth is open to debate and (3) as a priority, reducing the non-tax costs of operating a business.**

How should Australia respond to the global trend of reduced corporate tax rates?

> **There is no compulsion for Australia to develop a "follow the herd" mentality in public policy. The discussion should be what is best for this country in the context of its political system and economic resources. Taxes are a clog on economic activity and should be reduced in a co-ordinated effort if this is fiscally responsible. Australia already has a *de facto* rate of less than 30%. In the longer term, the European Union efforts against harmful tax competition will prevail.**

25. Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?

> **The Henry Report: 'Australia's future tax system' (December 2009) recommended that "dividend imputation should be retained in the short to medium term...." (Recommendation 37). This was practical and good advice which has not been diminished since it was made.**

If any change is made to reduce or eliminate franking credits, shareholder tax relief would first need to be designed to eliminate or reduce double taxation which is universally regarded as detrimental to an efficient taxing system.

Consideration can be given to reducing or eliminating the payment of excess imputation credits to super funds, charities and those individuals whose marginal tax rate is less than 30%. Such refunds may be justified but were not part of the original scheme announced in 1985 and are probably unaffordable in the current economic climate.

There is no substantiated evidence that the imputation system as a component of Australia's tax system is detrimental to an open economy such as the one in Australia. The taxation of profits derived by companies and the treatment of shareholders should be evaluated together with all forms of taxation and not piecemeal.

Discussion

Question 24 --- Tax rate competition and foreign investment

From the domestic standpoint, a reduction of corporate tax collections will increase the tax liability on dividend income received by residents; drive retail and institutional investors away from equity investments; lower share prices and. **Reduction of the 30% rate will: (1) collect less tax from foreign owned companies and will correspondingly increase the fiscal burden on domestic taxpayers and (2) make takeovers of Australian companies by foreign investors and hedge funds more attractive.**

The claim that Australia's international competitiveness is improved by a lower corporate tax rate has nothing to support it other than the frequency with which it is proclaimed. The aspirational statement that a lower corporate tax rate will bring increased foreign investment into Australia and/or that the statutory rate should be reduced to make Australia more competitive is unconvincing without evidence.

The claim in the DP (page 10) that:

> *Corporate tax rates that are increasingly uncompetitive will make it harder for Australia to continue to attract necessary investment. Ongoing investment in Australia is one of the key drivers of labour productivity and growth. Furthermore, high corporate tax rates increase the incentives for companies to engage in tax planning, such as profit shifting.*

is speculative and is not based on empirical evidence. **Credible analysis needs to distinguish between direct and portfolio investment.** Incidentally, the Henry Report failed to do this.

Capital investment is made by foreigners (as well as residents) with entrepreneurial intuition and long term strategy. Qualitative factors are not capable of reliable economic modelling.

For foreign investors, the **"costs of doing business"** is the driving force. **"Income tax does matter but not that much"**. The DP concedes that :

Tax is only one of many factors that affect Australia's appeal as a destination for foreign investment. Nevertheless, tax can have a significant impact on investment decisions.

Target rates for capital allocated to investments do not necessarily determine the investment decision unless, perhaps, there is a short term highly leveraged acquisition.

For example, investment from China in Australian agriculture will not be determined by a cost of capital calculation. The PRC has a dual policy of (1) strategic political investments, world-wide, and (2) export of capital to dampen the rise in the foreign exchange value of the yuan. Another important factor is the value forecast for the AUD in terms of the major trading currencies, especially volatility. Hedge funds and investment banks scour the economy for **"cheap assets"**. These factors are not reflected in the Box 5.1 on pages 79-80 of the DP. The linear relationship in the diagram is unlikely to be reflective of the real world. **Qualitative trumps quantitative.**

Multinationals and companies generally, make investment decisions on factors of their own choosing in the setting of their particular industry and positioning of competitors. Multinationals tend to manage foreign taxes as any other expense and take advantage of laws which permit the reduction of corporate taxes on profits and taxes on dividend, interest and royalty flows. Taxes are factored in on actual liabilities, i.e effective rates for the particular project, rather than a theoretical statutory rate.

International comparisons of statutory corporate tax rates are misleading because they ignore the actual economies and fiscal systems of the countries. Ireland has a corporate tax rate of 12.5% but this rate should be considered in the context of double taxation of company profits and a VAT rate of 23%. Statutory rates can vary from imposed rates after adjustment for concessions and exemptions as well as provincial, canton and state levies. There have been many reports claiming an effective Australian average rate of less than 30%.

The DP implies that if Australia is not a welcoming jurisdiction, foreign capital will go to a comparatively more favourable tax jurisdiction because of the "mobility of capital".

This may be a reasonable assumption in circumstances where there are identical investment opportunities located in different countries. For example, with mineral and hydrocarbon resources, such as bauxite which is an abundant resource in many parts of the world, the mining of bauxite is technically simple and cheap. This suggests that given the opportunity of choosing between locations, the lower headline tax rate country will be chosen. But, this is misleading because non-tax factors will prevail such sovereign risk, conditions to be negotiated (especially for royalties) and so on. These considerations are self-evident and do not need further elaboration here. **There is only one Cubbie Station and it is located in Australia.**

No statistical evidence is available that the statutory corporate tax rate of 30% has impeded the flow of private equity capital into Australia. According to World Bank statistics, ***net*** foreign direct investment capital inflows have been positive and consistent over the last 5 years or so. The proposition that they would be greater with a lower corporate tax rate is speculative.

According to the DP (page 80):

> *For multinational companies, a lower corporate tax rate would reduce the incentive for tax planning and profit shifting from Australia. This would potentially reduce the revenue that is lost to tax planning and allow the resources devoted to tax planning and compliance activities to be used more productively in the economy.*

Reducing the tax rate is unlikely to significantly reduce tax minimisation. Anecdotally, Hong Kong is a good example. It is said that as much effort goes into avoiding HK tax as would go into any other jurisdiction. **The issue is the quantum of tax that can be saved irrespective of the statutory rate.**

There is a logical fallacy in the abstract economic studies concerning cross border business activity and assumptions about the "mobility of capital ". Economic theories assume direct investment is sensitive or elastic to statutory corporate tax rates and attempts are made to establish relationships by statistical or theoretical methods. Such methodology may have merit for **portfolio** investment but in reality, **business chases profit opportunities**. Taxes and levies are secondary and not the motivating force. It is absurd to contemplate that a foreign entrepreneur would set up a manufacturing facility in Australia once the statutory tax rate drops to 12.5%.

References to a reduction in corporate rate in some countries e.g. the UK, followed by an improved level of economic activity are a *post hoc ergo propter hoc* fallacy. No causal relationship has been established.

Question 25 --- Imputation
Paragraph 5.1: Overview of the business tax system (page 73) includes the following claims:

> *(Dividend imputation) makes little contribution to attracting foreign investment to Australia other than eliminating dividend withholding tax for franked dividends paid to foreign shareholders. It also involves a significant cost to revenue and may impose more compliance costs to achieve similar outcomes to other jurisdictions.*

This statement is conjectural and incomplete.

The objective of dividend imputation is to prevent the double taxation of profits earned by Australian resident entities carrying on business in the corporate form when distributed to equity holders. The imputation system removes the differential treatment between business entities. Ideally, business activity should be taxed neutrally over the various forms of organisation allowed by law. This provides simplicity and minimises distortions caused by tax arbitrage. The DP acknowledges that imputation supports the integrity of the business tax system.

Imputation systems or their absence are not the policy vehicle for attracting or preventing foreign investment into Australia. As acknowledged in the DP, the true character of corporation tax under a full imputation system is that the tax actually paid is a domestic withholding tax on distributions to resident shareholders and a final tax to foreign investors. It is true that imputation is fiscally unfashionable at present. That is no reason to argue against it especially when nothing is advocated for a system of shareholder relief to prevent double taxation.

Regarding the claim of a significant cost to revenue, the Government retains a large proportion of the company tax collected because companies distribute much less than 100% of taxed profits. The Class C franking account balances of tax paying companies were $245.7 billion in the aggregate at 30 June 2012 representing tax collected but not allowed as an imputation credit, locked up in 345,696 franking accounts.

There is a drain on tax collections by refunding excess franking credits to certain taxpayers and entities mentioned on page 92 of the DP. This concession was not in the design of the system as introduced in 1987.

The Financial System Inquiry commented that dividend imputation may create a bias for domestic investors to invest in domestic equities. **This aspect of imputation is a benefit for the economy because Australia is a chronic importer of foreign capital to supplement inadequate domestic savings.**

The Inquiry also adds that imputation provides little benefit to non-residents that invest in Australian companies. Franked dividends received by non-residents are not subject to any further Australian tax liability such as withholding tax, which is a more favourable position than Australian individuals. The non-resident investors may have to pay a top-up tax in their home country when Australian source profits eventually reach them as dividends.

The implication that non-residents should be treated more favourably than residents is unfair and should be rejected. Under the current system Australians individual equity holders may similarly be required to pay additional tax on dividends received whether franked or unfranked.

As the DP recognises, imputation provides strong incentives for Australian-owned companies to pay tax in Australia. Full imputation dampens the incentive for domestic tax avoidance. This result follows because shareholders have a preference for companies which pay franked dividends. Therefore, imputation encourages corporations to have a policy of distributing a reasonable share of profits, under pressure from small shareholders and, especially, institutions in the superannuation sector. **In the absence of pressure to pay dividends, companies tend to hoard cash and make investment decisions without the discipline of efficient capital (debt and equity) management.** This effect was analysed many decades ago in the performance of companies in post-world war II Britain.

There has been strong lobbying by large Australian companies with foreign operations against the imputation system because off-shore income does not generate Australian tax and, consequently, imputation credits. It is claimed but not proven that there is a tax disadvantage for Australian multi-nationals to expand overseas. However, the payment of unfranked dividends to Australian shareholders is essentially no different to those shareholders making direct investments in foreign companies.

If the Government were to give franking credits for foreign taxes then the Australian shareholder would be subsidising foreign governments. There is no logical reason why the Australian tax system should subsidise investment overseas unless perhaps as a re-design of the existing Trans-Tasman imputation scheme.

The classical system of taxing profits earned by corporations distorts the forms of business organisation, discourages distributions to stake holders and encourages financing by debt rather than equity. The deleterious effect is best illustrated by the US experience prior to 2003 when partial stockholder relief was introduced. Because large, listed US companies paid virtually no dividends, US investors had to have an investment policy of regular sales of stock to cash in on their earnings equity.

According to the DP (page 83):

> *While the imputation system addresses some biases in the tax system, it leaves some issues unaddressed. As shown earlier in Box 5.1, company tax means that investments need to deliver a higher rate of return for all investors to attract non-resident investors. However, unlike non-resident investors, Australian investors do not face a higher tax burden from company tax, because of imputation. As a result, imputation effectively increases the rate of return for Australian investors.*
>
> *Australian investors therefore have an incentive to invest more of their savings in Australian shares rather than other investments (such as foreign companies). Further, because imputation does not offer relief from underlying foreign corporate taxes, it creates a bias against Australian-owned companies investing in foreign companies or engaging in foreign business activities.*

This is an intended result of the 1985 tax reform. An exposition on this aspect of imputation is in the Henry Report and includes the following comment:

> *To the extent that the tax bias against offshore investment actually has an effect, it may be beneficial from a national perspective. This is because paying foreign tax does not benefit Australians. Rather, it reduces the net return to Australians of the offshore investment of domestic savings. In contrast, paying Australian company income tax on a domestic investment helps fund transfers and public services. By restricting imputation to Australian company income tax and not giving a credit for foreign taxes, Australian companies treat foreign tax as a cost, so aligning their private interests with the national interest.*

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If you have any questions, I will do my best to answer them.

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