

BRAD

Chapter 2



EXPLAINING THE FULL IMPUTATION SYSTEM OF COMPANY TAX

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Chapter 2: explaining Brad's country's full imputation system of company tax

Brad and the others in the Tax Department's tax policy team, Claudia and Sami, continue with the excitement, wonder and intrigue involved in the the taxing of investment income: the income that comes from saving for future living rather than consuming now.

In this chapter, Brad and Sami are interviewed by a journalist on their country's full imputation system of company tax.

The interview produces quite a bit of heat both from Claudia and the Tax Minister. Nevertheless, from watching the interview, the Tax Minister understood better the full imputation system and its shortcomings, as well as options for future changes to it.

The full imputation system in Brad's country is strikingly similar the that in Australia, which was announced in the then government's 1985 Draft White Paper (see Preface) and and commenced 1 July 1987 in somewhat different format to that originally announced. The full imputation system removes the double taxation of company income that applied under the prior classical system of company tax: first at the company level and again in the hands of individual shareholders when distributed as dividends.

In contrast, the 2009 Henry Review, recommends (recommendation 37) that alternatives to imputation should be considered 'as part of a further consideration of company income tax arrangements' (p 198). TTPI (2020) canvasses a dual income tax system as an alternative to full imputation.

Officer (1990) specifically addresses the question of the cost of capital under full imputation in a country like Australia with a small, open capital market.

Dr Claudia, I've had a call from that journalist, Max, who keeps writing about tax issues.

He wants to talk in detail about our full imputation system of company tax, including the fact that some are calling for its abolition.

I don't want to make a big deal of it - so I wonder if Brad and Sami could handle him.

We're on it, minister.



Brad and Sami, the Tax Minister has asked that you meet up with that pesky journalist, Max, to answer some tax questions.

I know Max.

Sounds exciting, Claudia.

He wants to ask a series of questions on our full imputation system.



Do you think you can help him out without causing a splash on the front page?

Of course. No problem.

Sounds exciting, Claudia.



Do you think you will be able to handle this, Sami?

It will be all good, Brad.



Brad and Sami on camera

I'm Max and we have Brad and Sami from the Tax Department with us this morning to answer questions about our full imputation system of company tax.



I am pleased that I was able to get these two to come along for this session because they are known to have quite different views on imputation.

Go Max!

How does Max know that?



Brad believes that imputation has significant deficiencies and that its retention is a line-ball decision.

Sami appreciates that imputation is not perfect but sees it as a solid springboard to a more refined system.

OK. Let's get started.

Hey, not too positive on Sami's view, Max.



How does full imputation work?



Starting on the domestic front, individual shareholders pay tax at their marginal personal tax rates on dividends out of the their companies' profits from local activities.

While shareholders also get taxed on these dividends paid out of profits that have been taxed in their companies - "franked" dividends - they get a credit against their own tax bill for the prior company tax paid on the dividends.

Dividends from profits that have not been taxed because of concessional treatment - "unfranked" dividends - are simply included in the shareholders' assessments.



That's right. Say, a local company makes \$100 taxable income per shareholder from local activities, pays \$30 tax on it and distributes the remaining \$70 as franked dividends along with \$30 franking credits for tax paid on the dividend.

Local individual shareholders then include an amount equal to the company's **original \$100 of taxable income** in their own personal income tax assessments.



That's because they include in their assessable incomes not only the \$70 of cash dividend but also the \$30 of franking credits.

In addition, of course, their overall tax payable is reduced by the \$30 of franking credits, reflecting the \$30 of tax already paid by their companies on their behalf.

Thus, a shareholder on a 47% tax rate would pay an extra \$17; that is, \$47 tax on the original \$100 (franked dividend plus credit) less the \$30 franking credit.

A shareholder on a 15% tax rate would get a net \$15 credit which is either subtracted from tax payable on other income or refunded in cash.

Oh, so shareholders are being taxed on the same taxable income as their companies!

Yes. Immediate distribution of franked dividends sees tax under imputation neatly match that paid by someone earning the \$100 directly or via a trust or partnership.



But post-tax differences between shareholders and direct investors could arise if the \$100 of company profit came from offshore and was taxed there first.

Or, if the \$70 of post-tax income in the company is retained for some years before being distributed.



Yeah, yeah, Brad, we can pick up such details later.

I can see now that "full" imputation provides credits for all the local company tax paid on dividends and seeks tax treatment for local shareholders equivalent to that of unincorporated investors.



But what about people getting refunds of franking credits when they have paid no tax. Some say that is just a gift or that the companies have paid the tax, not their shareholders.

Certainly a lot of tax revenue would be saved if people were denied refunds for franking credits that were greater than their tax payable on unfranked dividends and non-dividend income.



Shareholders are the owners of their companies and therefore their companies' taxable income.

Regardless of their personal tax rates, shareholders who receive franked dividends have had tax, at the 30% company tax rate assumed here, taken out of the dividends before they receive them.

Even though their companies send the 30% of tax off to the government, it is the shareholders that have had the tax taken from their dividends.

No one says people have not paid tax when superannuation funds take 15% tax from their contributions and send that to the government.



So, this argument that shareholders get refunds of excess franking credits when they have paid no tax is a complete furphy.

Shareholders receiving franked dividends have already had 30% tax taken from the dividend.

And our imputation system ensures that all of that 30% is refunded if the shareholders' tax rate is zero after the inclusion in their tax assessment of the amount of franked dividends plus franking credits.



Most notably, people in this category include those in the pension phase of superannuation, as well as those who are below the tax-free threshold after including franked dividends plus credits in their personal assessments.

They pay nil tax on other income from local direct investments in property or bank accounts. Our full imputation system ensures the same result for investment via companies, at least when the company distributes.

If they got no refund of excess franking credits, they would pay 30% tax instead of nil tax on their companies' taxable income underlying the dividends.



In numbers, if they receive \$70 of franked dividends, they should pay zero tax on the \$100 of original company income - that is, their \$70 dividend plus \$30 franking credits - just as they would pay zero tax on interest or property income.

The only way they can pay zero tax is to get a full refund of the \$30 of prior company tax taken out of their dividends.



Sounds like the zero rate on superannuation pensions is the issue, not refunds of excess franking credits.



You say dividends out of companies' profits untaxed here are unfranked.

But how are profits measured for this?



Yes, distributions out of current and prior profits untaxed here comprise assessable unfranked dividends.

And distributions beyond current and past profits represent a non-assessable return of capital.



So, it is logical to ask how profits are measured for tax purposes.

And, conceptually, our imputation and capital gains tax, or CGT, arrangements are flexible enough to accommodate various measures of profit.

Those profit measures may range right up to full commercial profit, say, from company accounts.

CGT arrangements?

What if accrued gains were not included in your commercial profits?



If profit for tax purposes excluded accrued capital gains from commercial profit, cash distributions beyond franked dividends would result in lower amounts of unfranked dividends and higher returns of capital.

Then, because returns of capital reduce the CGT tax value of company shares,* the profit not included in unfranked dividends should be picked up later on the sale of shares - delaying tax revenue collections.

And what about situations where companies do not distribute and shareholders do not sell shares?



Well



OK, OK. Let's move on. Getting a bit too technical for our viewers.



* See Ch7, pp 5-6.

Isn't our country just about the only country applying full imputation?



Our country, Australia, New Zealand, Mexico and Chile are in a small group of OECD countries that operate a full dividend imputation system.*

Many countries in Europe like UK, Germany, Finland and Norway, as well as Singapore and Malaysia, have abandoned their full imputation systems.



The European countries probably all exited to comply with EU rules – I think to do with conflicts between the tax treatment of foreign-sourced dividends, which may be double taxed under imputation, and locally-sourced dividends.

The key point here though is that many countries have arrangements that provide some relief to individual shareholders from the two layers of tax they could otherwise face on their dividends: once in their company and again when they receive their dividends.

Why replace complete relief from classical double tax on locally-sourced income with some form of arbitrary partial relief?



In fact, I think we and Australia have the purest full imputation systems in the world because of the availability of refunds of excess franking credits.

This means, as explained earlier, shareholders get a refund of those credits attached to franked dividends that exceed their tax on all components of their annual income: non-dividend income, unfranked dividends and franked dividends plus attached credits.

Their company's taxable income distributed to them will be treated in their hands consistently with all their other types of taxable income like interest income or, in the case of individuals, wages.

If the company distributes immediately.



* Henry Review, p 191.

Is imputation outdated?



Yes. The benefits of imputation have declined as our economy has become more integrated into the global economy.*



What are those reduced benefits, Brad?

Benefits regarding financing neutrality have declined and the bias for people to over-invest in certain domestic shares has increased.

And imputation has not reduced the cost of capital.



But, companies' cost of capital comprises investors' minimum required returns from the companies' debt and equity.

And we opened up our small capital market to the world well before imputation was introduced.



With free capital flows, returns to debt and equity tend to equilibrate everywhere as investors seek best outcomes.**

Against all that, I would argue that required returns to debt and equity here would not have been greatly affected by the change to imputation.

But that does not imply no change to the capital structures of companies here in response to removal of the double taxation of dividends.**

You should ask us more about imputation's local equity and financing biases and its effect on the cost of capital.

Please do, Max!



OK.

* Henry Review, p 198.

** Officer (1990), pp 369-371.

Does imputation bias local investors towards local companies that are investing locally?



Yes. No credit is given to local shareholders for foreign taxes on income coming back to them through their local companies.*

Local companies do pay some of our tax on any foreign income that attracts our foreign tax crediting arrangements and has been taxed at a rate lower than our company tax rate.

But, the bias arises because local shareholders face double tax on other taxed foreign income received by their companies but only a single layer of tax on their companies' local income.



This bias is not the fault of full imputation itself.

Regardless of design of company income taxation, double taxation of dividends out of foreign income can only be removed by having credits for foreign taxes on that income flow through local companies to individual shareholders, with refunds of excess credits where necessary.



Local shareholders would then be taxed consistently with individuals who currently get credit for foreign taxes when they invest elsewhere directly, or via trusts.

Our imputation system could neatly accommodate such flow-through of credit for foreign taxes to local individual shareholders by simply adding the foreign taxes to our companies' franking accounts.

At great cost to income tax revenue!



You Tax Department people certainly have a different slant on some of these issues.



* Henry Review, pp 196-197.

Does imputation impose a bias between debt and equity funding of local companies?



Yes, there is a bias towards debt because companies get a deduction for interest on debt but get no deduction for the equity funds that shareholders have tied up in their companies.*



That is not correct. The decision to introduce imputation focused on the removal of the classical system's double taxation of equity funding and its effects on decisions, say, regarding dividends versus retentions and business structures.

It is logical that removal of this double tax would see our companies financed by a greater proportion of local equity, relative to local debt if they have a high proportion of local shareholders.**

You see, the investment activities of companies might be funded locally by borrowing, say, by issuing bonds, or by raising equity capital from shareholders.



Interest payments on bonds paid out of a company's profits are deductible to the company and taxed in the hands of the bondholders.

And we have seen that dividends, paid out of a company's profits, are taxed at the tax rates of the local shareholders receiving them.

So, you see, on the domestic front, there may be no debt/equity bias.



What?
No!

There is the prospect of one layer of tax at shareholders' tax rates on annual returns to equity funding.

And there is one layer of tax at bondholders' tax rates on annual returns to debt funding.

In fact, retaining income under imputation currently means delaying tax at shareholders' rates on that income. That provides the ingredients for a bias towards equity funding of investments - via new equity or retained earnings - at least for high income shareholders.

Look, Max, Sami admits she is only viewing all this on the domestic front.

Foreign debt investors have a big roll to play here.



Interest on foreign debt is only subject to local interest withholding tax, or IWT, at very much lower rates than our company tax taken out of franked dividends going to foreign shareholders.

In fact, in some circumstances the debt is exempt from IWT.*

So, you can see here the advantage that foreign debt funding has over equity funding.



Certainly, the general IWT rate is relatively low at 10% on the interest paid by local borrowers on foreign debt - with many exemptions applying.

And, I seem to remember that earlier attempts to remove some particular IWT exemptions did not proceed when the non-resident lenders argued that they had the market power simply to increase interest charges to offset IWT payments - despite the possibility of credit for IWT payments at home.

There, as I said.....



But, Brad, you're missing one obvious point.

What is that, Sami?



The IWT arrangements have nothing to do with imputation design. They apply regardless of our form of company income taxation and its accompanying tax impost on non-resident shareholders.

Imputation design is focused on achieving one layer of tax on shareholders' equity investment, down from the two layers under our prior classical system.

Hmmm.....



For debt/equity analysis, it is best to get the basics right on the domestic front and then add non-resident complications.



OK, so....

* Henry Review, pp 180-182.

So, imputation has reduced the cost of equity capital for local companies?



With the removal of the double taxation of dividends, imputation has put balance into local companies' debt versus equity funding from local sources.

More broadly, local or foreign debt or equity investors require returns here commensurate with the risks involved, including any relevant possible exchange rate movements.



As I said earlier, the financial cost of capital facing our companies comprises a weighting of investors' required returns to debt - as interest - and equity - as dividends.

Consequently, the annual return of an investment that is just breaking even will just match the returns demanded by debt and equity providers, or the financial cost of capital.

It seems reasonable that the returns of a project that is only just viable will only just cover the cost of funding it.



But, as noted, the fluid worldwide financial markets largely set the required returns to debt and equity funding in a small country like ours with an open capital market.*



That means the particular design of our company tax system, be that imputation or classical, is unlikely to have much effect at all on the cost of capital of our companies** - despite common claims to the contrary.

The introduction our full imputation system therefore should not have significantly affected the cost of capital for most companies here - though those with mostly local shareholders might have increased their equity funding share.

Err, I suppose

The impact of our company tax rate on foreign equity investors is, however, a different matter.



Interesting, Brad.....

* Officer (1990), pp 368-369.

** See Henry Review, pp 193-194.

Does imputation affect the level of foreign investment coming into our country?



Reduced company tax rates around the world have diverted investment funds away from our country, despite the high profits available in our mining sector.

That has pushed up the break-even pre-tax returns that are required from opportunities here to attract foreign investors, choking off some less profitable ventures.*

Imputation is not sensitive to these international effects.



Any increases in break-even rates of return of local investments caused by low company tax rates elsewhere have nothing to do with imputation.

Any system that taxes company profits could have the same effect.

A small country like ours is risking diversion of international equity funding if it has a company tax rate that is significantly higher than in other countries that are comparable in terms of institutional arrangements, sovereign risk and investment opportunities.



It is important, of course, to go beyond just comparing headline company tax rates because additional tax on dividends applies in some countries, both at the regional and personal levels.

But, if the level of our company tax rate is a problem for us it is addressed by reducing it, not messing with imputation.

I didn't say we should mess with imputation now.



I'm liking the discussion.



Look, Brad rightly speaks of the importance of lower tax rates on foreign equity investors.

Exactly.

And imputation has helped, not hindered, in this regard.

How is that, Sami?

?!?

Our imputation design removes the extra layer of dividend withholding tax, or DWT, that applied to dividends out of taxed company income paid to foreign shareholders under our former classical company taxation.

Unless the foreign shareholders already attracted a full credit in their home country for our DWT, the change from classical taxation to full imputation would have provided them an immediate 5 to 15 percentage point reduction of tax on their dividends paid out of taxed income.

Imputation removes double tax on dividends not only for local shareholders, but foreign shareholders as well. DWT now only applies to unfranked dividends paid to foreign shareholders.

Sounds like a reasonable point, Brad.

Aww, come on, Max!

If required investment returns are increased here because of our company tax rate, would that mean imputation credits are a tax subsidy?



Yes they are.

Take the, admittedly extreme, example of tax-exempt US pension funds looking around the world for investment opportunities.

Say, they are expecting to be able to get a 7% pa return on debt and equity investments taking into account risks involved and expectations regarding exchange rate movements.



If the funds could access the required 7% on their debt investments in our country they would likely qualify for exemption from interest withholding tax on the interest payments going back to them.

But if their alternative corporate equity investment here was subject to our 30% company tax, the investments would have to earn a grossed-up 10% before tax for the pension funds to get their required 7% return.

Our 30% company tax rate might see equity investment by the funds, and other foreign investors similarly affected, diverted elsewhere, pushing up required pre-tax corporate returns here to 10% - choking off less productive investment opportunities.



Imputation then gives local shareholders a full credit for the 30% of company tax on the bolstered 10% pre-tax return of those company projects that do proceed.

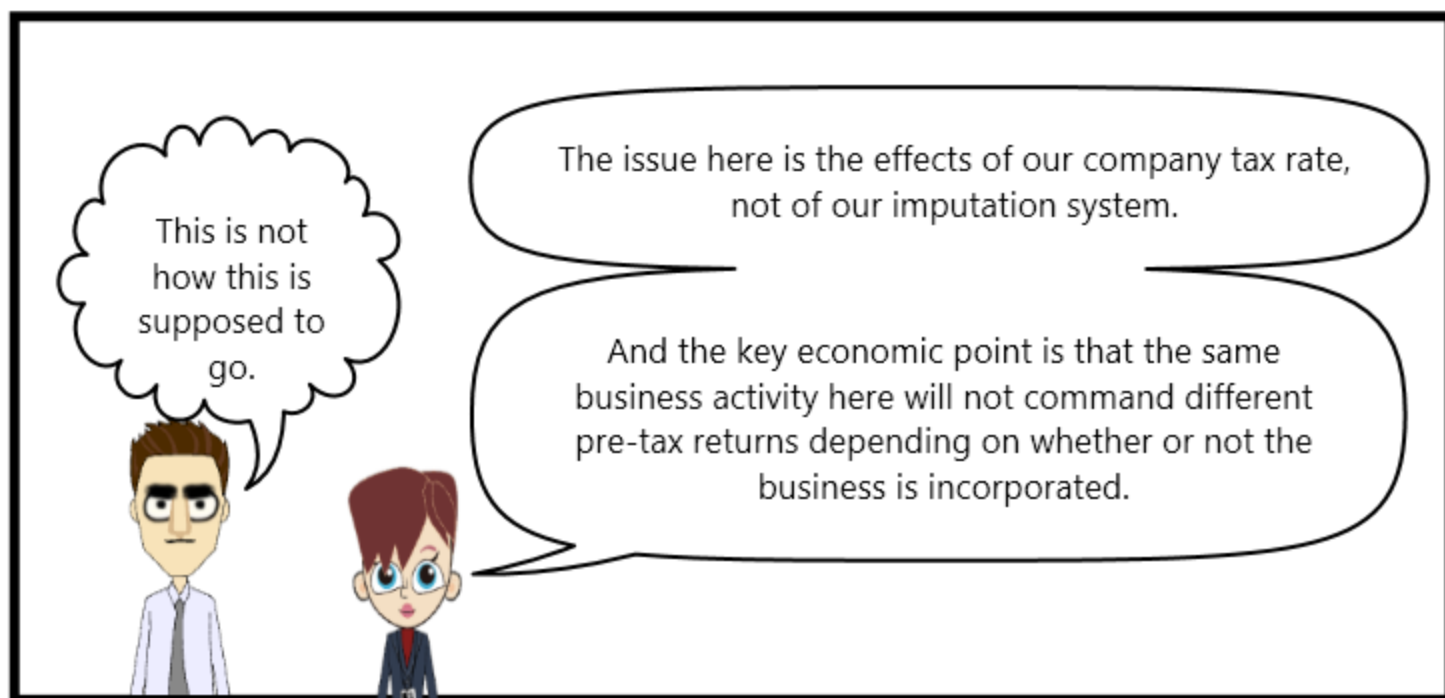
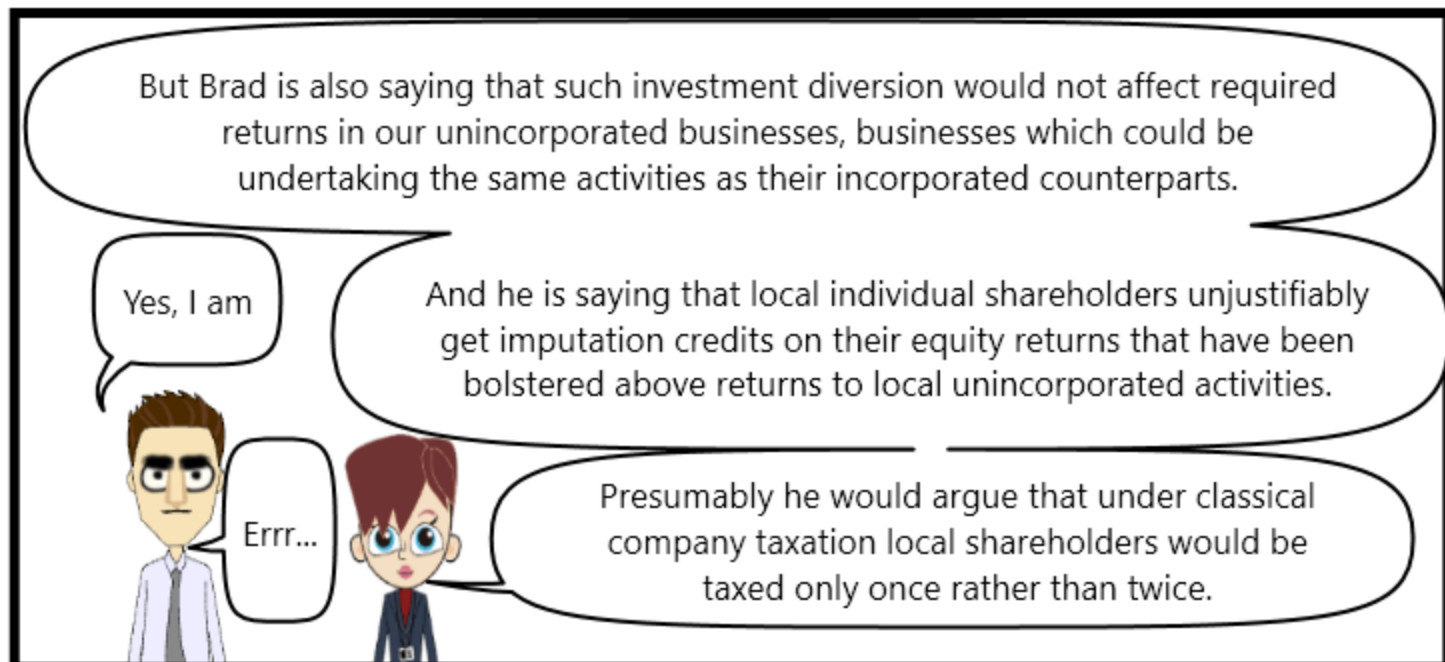
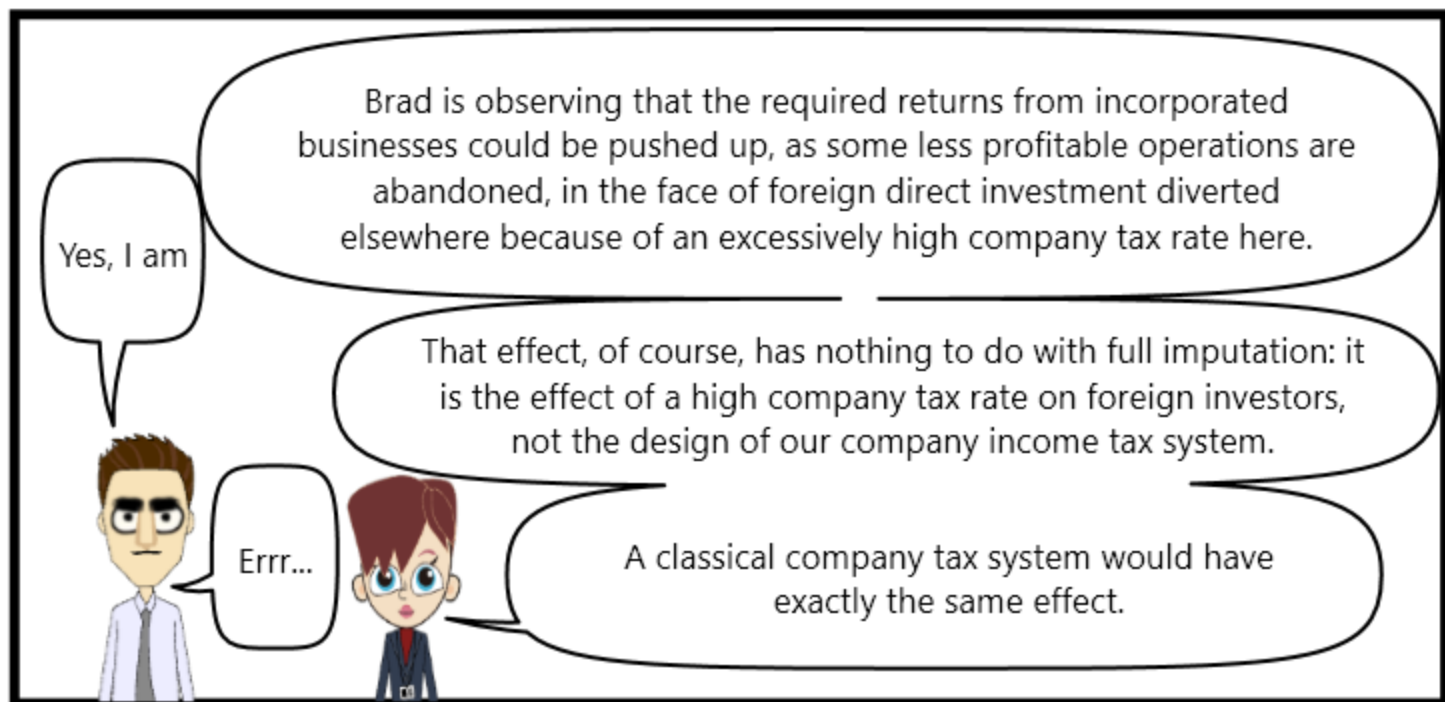
Someone on a 30% personal tax rate, for example, gets a post-tax return of 7%, which is the pre-tax return that local investors get outside the corporate sector.

Local shareholders therefore get imputation credits for company tax that just reflect the extra grossed-up returns caused by the company tax rate.

The credits are clearly a tax subsidy to local shareholders because they effectively face no net company tax on their net 7% return thanks to our small, open economy.*



* Henry Review, p 76.



Any higher pre-tax returns in the corporate sector caused by foreign investment diversion would have to spread and equalise across the same activity in both the corporate and unincorporated sectors.

Don't companies have a monopoly on the increase in returns?



That effect alone immediately removes any suggestion that imputation credits are a subsidy to local corporate investors.

In any case, there is a whole range of other reasons why the grossing-up effect of our company tax rate on pre-tax returns would be lessened.

Foreign investors could choose to invest in local companies via direct or intermediated debt instead of equity.



Some foreign equity investors might not be greatly affected by a high company tax rate.

They might claim a credit for our tax against their home country tax bill.

Or, they might be able to avoid its effects, perhaps by negotiating around our franking credit trading rules.

Overall, whatever the net effect on pre-tax returns across particular local activities, imputation is working dispassionately in the background ensuring that local individual shareholders are only paying a single layer of tax on their dividends from their local companies undertaking those activities - like the owners of their unincorporated competition.

Thank you, Max.



Nevertheless, foreign equity investors do have to confront our company tax rate.



Do foreign shareholders value our imputation credits?



Imputation credits are of no value to foreign shareholders, tax exempt or not, because we do not provide refunds for our franking credits attached to their dividends.

And we have franking credit trading rules aimed particularly at foreigners recycling them to locals by, say, selling out to locals after holding shares in a local company for only a short period around ex-dividend date.



There is no justification for the country running an imputation system, or any system imposing company tax for that matter, to provide refunds to foreign shareholders for company tax underlying their dividends.



The home countries of shareholders receiving dividends from elsewhere may apply exemption or foreign tax crediting to those dividends. Exemption ignores the amount of foreign company tax underlying the dividends and crediting is invariably limited to the home country rate of tax on the dividends.

Nevertheless, imputation franking credits are clearly shown on dividend slips. Thus, they can be valuable to foreign shareholders if their home country gives credit for them.

Moreover, under imputation, full crediting is more achievable without an additional layer of tax in the form of DWT on franked dividends.

Aww, Max!



You two really have to sort your differences out!



What does imputation offer investment decision-making within Australia?



I have already explained how imputation works, Max.



Break-even returns of local investment opportunities reflect risks involved and the interaction with the global economy, while imputation provides local financial and investment balance:

?!?

better balance between debt and equity funding of local companies and their decisions to distribute or retain income; and

better decisions on business structures with imputation seeking to achieve a single layer of tax on investment income consistent with that faced by the self-employed, partnerships or trust investors.

And, we saw how imputation is working away dispassionately, regardless of whether or not diversion of foreign equity funding has pushed up local returns generally and the extend of that effect.



Say, all annual income from investments in the local corporate and non-corporate sectors is taxed here and annual company income is distributed immediately.

In these circumstances, imputation would ensure that annual break-even returns of local investments were reduced everywhere in proportion to local peoples' tax rates,* just like the effect of tax on your bank account.

The result? Minimal interference of income taxation in investment decision-making, resulting in improved productivity and long-term growth.

A bit technical, Sami. But I see the consistency aim of the imputation system.



* Swan (1976), p 172.

Can you identify any other benefits of imputation?



Imputation does provide integrity benefits with relatively low tax administration and compliance costs.*



Widely-held local companies with local shareholders have an incentive to distribute rather than retain taxed profits, an incentive that was particularly strong when the top personal tax rate was at, or close to, the company tax rate.

Mirroring its biases, imputation puts a premium on local profits and encourages local companies to bring their foreign profit-making home and discourages them from shifting local profits offshore.

Administration and compliance costs are lowered because widely-held local companies with local shareholders spend less time and effort minimising or deferring tax payments.



I agree and add that, with shareholders now liking increased dividends, the incentive to gear up is reduced and corporate governance is fostered by shareholders' greater incentive to scrutinise their companies' investments and investment strategies.

Its legislation is complex, though.

And it costs a lot of tax revenue.



All company tax systems are complex.

So do depreciation allowances.



Sami might have you there, Brad.



* Henry Review, pp 194-195.

What are imputation's shortcomings that might point to design change?



I'll jump in here. I acknowledged shortcomings earlier.

First, some don't like dividends paid out of untaxed profits, or unfranked dividends, being taxed in the hands of local individual shareholders.

They say this results in a somewhat different tax outcome to that of trust investors, as well as direct investors or sole traders. But, Brad and I reckon this is great for revenue integrity, and it is closer to the ideal of taxing all profits each year.

DWT applying to foreigners' unfranked dividends also adds to integrity and benefits our country.



Secondly, and more pertinent, retained taxed income, which increases share value, can be taxed again when people sell their shares, with that temporary double tax not relieved until that income is distributed.*

In some specific circumstances also, interplay with the CGT discount for individual shareholders can cause permanent double tax.*

Finally, and most importantly, closely-held companies have the opportunity to delay distributions until their individual shareholders are facing a low or zero tax rate.

Instead of income being taxed at shareholders' rates when earned, company tax initially paid on that income might be fully refunded to shareholders as excess imputation credits.



The use of complex company-trust structures, designed to exploit Sami's last point, is one of the reasons why I see dual income taxation replacing imputation.



Dual income taxation doesn't solve structuring and has major integrity issues....



Hang on you two. I've got a couple of other questions on alternative design.



* Mayo (2011), pp 179-194.

Why not allow only partial credit for company tax paid on dividends to fund a company tax cut?



Yeah, as we discussed earlier, the reduced company tax rate would draw in more foreign direct investment.

Local activity would increase.

The associated capital deepening, more capital per worker, would also increase labour productivity....

....with consequent increase in wages.*



What Brad describes are one-off effects of a reduction in our company tax rate.

A one-off lift in the level of local activity and labour productivity.

And, on the other side of the lift in labour productivity is a reduction in capital productivity as more capital investment is added to the mix.

So, the effect on the overall level of productivity is uncertain.

?!?



Moreover, partial imputation, with its double taxing of dividends, loses all the benefits that full imputation provides by way of local balance in, say, debt versus equity funding and the tax treatment of shareholders versus sole traders and trust investors.

The result would be reduced overall productivity on an ongoing basis - with an accompanying ongoing reduction in long-term growth.



Trading ongoing growth for a one-off lift in the level of activity does not sound very smart.



* Henry Review, p 152, 199.

What about replacing imputation with a cash flow tax for companies?



Wow! A cash flow tax is designed to tax economic rent and not the regular returns from investments.

No tax would be collected on regular company income while that income is retained in companies.

Meanwhile, sole traders, trusts and partnerships would be taxed every year on their overall taxable income.

I'm not sure what tax local or foreign shareholders would face when companies do distribute.



In Australia, there was a failed attempt in 2010 to impose a cash flow tax called the Resource Super Profits Tax, or RSPT, on mineral resource projects. But the RSPT was to apply in addition to company tax.

Replacing company tax with a cash flow tax would be like having the RSPT apply to all corporates without the addition of income tax: a CSPT in isolation.

Yeah. All that for little tax.



No doubt a CSPT would exclude financial transactions, which means special provisions would be required if any tax were to be sought from financial institutions*, like banks, or the financial activities of any company.

That's right, Brad, like the RSPT, a CSPT would impose a capital levy on existing investments unless their market value was allowed as a deduction.

Levy aside, there would be suddenly nil tax payable on regular returns if a sole trader incorporates!

And then nil value of tax would be expected from them - even from economic rent.



Well, you two certainly agree on that one!



* Garnaut (2020), pp 471-472,

What about giving companies an annual deduction for the interest cost of equity funding from shareholders?



That is clearly a very logical proposition.

Allowing an annual deduction at a specified interest rate on companies' equity funding would align with the deduction they get now on the cost of their debt funding.

There would be no longer any bias between companies' debt and equity funding.



Such proposals for an allowance for corporate equity, or an ACE, have been around forever.*

The interesting thing with an ACE is that it turns the company income tax into a cash flow tax.

What? No.

You see, as with deductions for interest on debt, deductions for interest on equity remove any tax on the regular company returns that underlie the equity funding. Tax only applies to any returns above those regular, or "normal" returns - that is to any economic rent.**

So the disadvantages of an ACE are similar to those of a corporate cash flow tax.

I want income taxed.



No tax would apply to regular returns paid to foreign shareholders.

Unincorporated businesses could avoid tax on regular returns simply by incorporating.

Then there is the capital levy on existing companies.



Remember, too, on debt versus equity, we saw how imputation can impose a bias towards equity, rather than debt, for some local investors.

If you don't like a corporate cash flow tax, Brad, looks like you should also not support an ACE.



* See, for example, Henry Review, pp 164-165, p 199.

** Swan (1976), p 176.

What do each of you think should be the plan for imputation in the future and why?



Imputation has passed its use-by date.

Serious consideration could be given to replacing imputation with a dual income system, say, where wages are taxed on a progressive schedule but investment income is taxed at a uniform low rate.*

That would allow the company tax rate to be set at a competitive level internationally and stop some shareholders effectively choosing the tax rate on their dividends.



We have done all the hard work to turn our imputation system into what is the best interface in the world between companies and their shareholders.

We have absorbed the associated, justifiable tax revenue cost of removing double tax on dividends and providing refunds of excess imputation credits.

Administration arrangements are well bedded-in, as is the interplay between CGT and imputation design.

The time is right to upgrade imputation to remove current blemishes, saving tax revenue, increasing productivity and providing a sound basis for reducing the company tax rate.



The upgrade is called integration, which involves integrating a company's retained taxable income directly into the annual tax assessments of its shareholders.**

Whether retained or distributed, companies' annual taxable income is taxed at local shareholders personal tax rates.

The company tax rate is there to tax the income being distributed to foreign shareholders.



We have a competition here between so-called dual income and integration designs.

Let's look briefly at each in a moment.



* Henry Review, pp 71-72.

** Mayo (2011), pp 210-240.

But first, you both talk about cutting the company tax rate.

What about allowing accelerated depreciation instead?



If a cut in the company tax rate is not possible, investment allowances and/or accelerated depreciation on plant and equipment would be a second-best alternative.

I can't agree, Brad.

There is not even a trade-off to be considered here.

!?!



First, if just a single business got fast or increased write-off, investment flows would be diverted towards it.

But, with all businesses getting such a concession, prices of equipment would increase and interest rates and the exchange rate may adjust.

After all the adjustments, some businesses might be better off - perhaps the more capital intensive - but others would be relatively worse off.*



Second, fast write-off distorts investment decision-making*...

... decisions like: long-lived versus short-lived assets, repairs versus capital improvements, leasing versus borrowing to buy, and so on.

Unlike a cut in tax rates which reduces tax payable on taxable incomes everywhere, such measures represent distortive structural change to the tax base.



The income tax base for investments is the same under integration and dual income taxation. How tax rates are applied to that base is different.

I can agree with that.

It might increase investment for a while.



But, under either system, fast write-off reduces productivity and long-term growth.

You seem quite passionate about this, Sami.

Let's get back to both your views on alternatives to imputation.



* Mayo (1984), pp 38-39, p 44.

What would dual income taxation look like?



Income from investments, or the "capital" tied up in them, would be taxed at a low, uniform "capital" tax rate matching the rate of the first personal income tax tranche above the tax-free threshold.

And wages, or "labour", income above that first tranche would continue to be taxed on a progressive scale.

The company tax rate would match the low "capital" tax rate.*



The income tax base could be broadened more easily in light of the low capital tax rate.

And the income of widely-held companies, having been assessed and taxed on that broadened base, would be tax free when distributed. Similarly, taxable income of widely-held trusts would be taxed at the capital rate if distributed.

However, specific design features would be needed to address artificial conversion of labour income to capital income with sole traders and closely-held trusts.

The taxable income of sole traders and closely-held trusts, up to a set imputed return on opening tax value of their business assets, would face the low "capital" rate - with any residual, "labour", income facing progressive rates.



Similarly, with closely-held companies, dividends could be tax free to local individual shareholders up to the point where they achieve a set imputed return on the tax value of their shares, beyond which they would be taxed again at the "capital" rate.

The double taxing of these shareholder returns above the imputed rate would roughly align with the top personal tax rate for "labour" income to try to stop controlling shareholders' shifting labour income to capital income.



Big incentive to delay this double tax by retaining profits and lots of boundary lines with admin and compliance issues!



Sounded simple at first, Brad, but.... Hmm....

* See one design in TTPI (2020), pp 53-57.

What would integration design look like?



Ideally, current-year taxable investment income should be taxed at the current personal tax rates of the individuals undertaking the investment.

But, keeping to the local scene again, that only occurs for individual shareholders under imputation when companies immediately distribute their taxable income - as franked dividends plus franking credits.

Integration of taxable income seeks to have companies' annual taxable income taxed at shareholders' tax rates even when that income is retained.



What? Shareholders could be taxed on income they have not yet received!

It's their income after all. And, if their tax rates are below the company rate, they would realise net tax credits for the retained income.

The effect on shareholders would be just like current dividend reinvestment plans where shareholders agree to be taxed on dividends even though their companies retain the funds for investment purposes....

....though, with integration, this would occur automatically when companies retain taxed income.



You can see how integration brings the taxation of shareholders and their companies' annual taxable income further in line with the taxing of investment income of sole traders, trusts and partnerships.

For example, a small business owner, whether incorporated or not, would include in the same tax assessment, current year taxable income from: business activity - including retained taxed income if incorporated; any owner's wages; plus separate investments in shares or financial instruments.



Unlike dual income design, there are no boundary lines separating modules of investment activity attracting differential tax treatment.

To bring shareholders' outcomes even closer to those of sole traders and trusts, CGT cost base reductions could be made to companies' shares for all distributions not out of taxed income.

Paralleling current CGT cost base adjustments for fixed trusts,* these adjustments would mean unfranked dividends are not taxed immediately - though unfranked dividends could be retained for their integrity benefits.

Talk about complexity!



Similarly, to avoid double tax on any retained taxed income should shareholders sell their shares, increases in the CGT cost bases of the shares would match the amount of annual taxed income that exceeds cash distributions.**

With all current-year taxed income of companies allocated to shareholders along with franking credits, regardless of cash distributions, franking credits are not stored in accounts.

So you can see how integration deals with the wrinkles of imputation: removing entirely the tax incentive to incorporate and associated equity funding bias and the ability to manipulate refunds of prior company tax.

Sounds so perfect!



Most importantly, with annual taxable income attracting personal tax rates everywhere, investment decisions are least distorted, increasing productivity and long-term growth.

Sami, you know there would be difficult practical issues to address like: the allocation of retained taxed income when a company has different classes of shares; and dealing with non-resident shareholders.



* See Ch6, pp 7-9.

** See Ch6, pp 10-14.

Just imagine if every country ran a common integration system of company tax, with full mutual recognition between countries, including credit for company tax underlying retained taxed income, and refunds for excess franking credits for their local individual shareholders.

Investment decisions all around the world would be based on commercial worth, little affected by income taxation.

Tax ideology now on national TV!!



We will have to stop there. Thanks for coming in. Perhaps you two could come back for some more healthy debate on other tax topics.

"Debating" does not sound good, Max.

Thank you.



Grrrr...

Not happy, Brad?



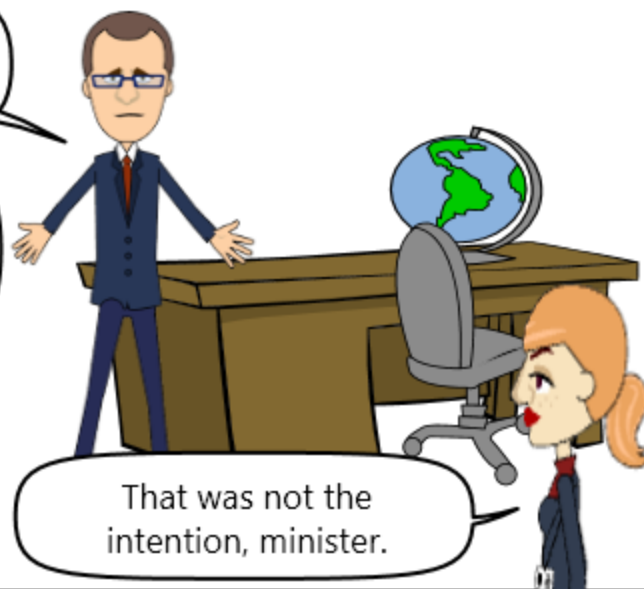
Reaction to Brad and Sami on camera



What were those two doing, Claudia?

They were supposed to provide a bland discussion on imputation.

They had differing views on imputation itself and where to take imputation in the future.



There is a big problem here, Claudia.

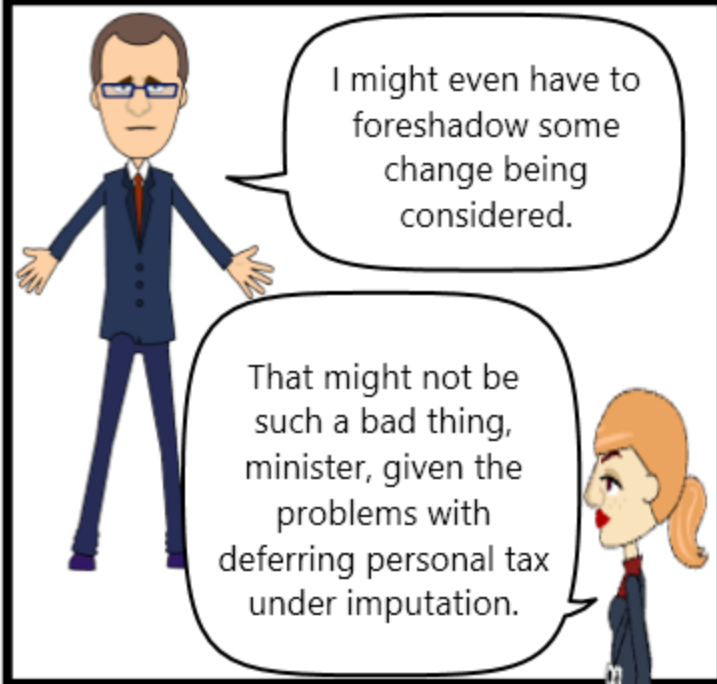
I can see I'm going to be under pressure to respond publically on imputation.

Yes, minister.



I might even have to foreshadow some change being considered.

That might not be such a bad thing, minister, given the problems with deferring personal tax under imputation.





Mind you, I watched the TV session a few times as I cooled down and found some of the discussion useful.

Both Brad and Sami discussed change in structural tax design that would ease the way towards reducing the company tax rate - though they had very different designs.

Yes, Sami's redesign would see company tax treatment upgraded from imputation to integration.

Whereas Brad's dual income tax design would not only affect our companies but much investment activity here.



I must say I did not not like the boundary lines that dual income taxation would create between Brad's so-called "capital" and "labour".

As well as having to come up with some sort of imputed return on capital for sole traders and closely-held trusts and companies.

Most particularly, how could I sell the unfairness of taxing investment income at a low rate, aligned with the company tax rate, and still have wages taxed at progressive rates above that?

Of course, with integration, I'll be pressured on why we should tax shareholders on taxable income that they have not received as cash.

Claudia, get your team to work through the issues related to upgrading imputation to integration, including the practical issues that Brad mentioned, and brief me.

Yes, minister.

