Comments on the PC's company *Cash Flow Tax* proposal

The Productivity Commission (PC) has requested feedback on its proposal to increase investment by lowering the existing *Corporate Income Tax* (CIT) rate to 20 per cent for companies with an annual turnover below $1 billion, and applying a 5 per cent *Cash Flow Tax* (CFT) to all companies. I submit this will not achieve the PC's investment goal, but will add unnecessary compliance costs, increase revenue unpredictability, and create new opportunities for tax minimisation.

The specific CFT design features that cause problems are as follows:

- Very large companies (over $1 billion turnover) will continue to bear the 30 per cent income tax rate and will have the CFT applied in addition. While the PC's assertion is that these companies will invest to mitigate the effect of the CFT, the incentive is small, being the value of *deferring* the extra 5 per cent charge until the company's cash flow becomes positive.
  - If CFT losses can be offset against CIT this would significantly reduce CIT revenue in any given year and make company tax collections highly unpredictable.
  - Optional offsetting would encourage tax planning while increasing compliance costs.
- For the CFT to tax higher profits effectively, it must operate without imputation or with a modified imputation system. This additional complexity and lack of transparency in the imputation system will confuse and deter investors, and may decrease the after-tax return directly, for domestic shareholders who bear the CFT without the benefit of franking credits, or indirectly, by franking credit wastage in company groups.
- It is unlikely that the reduction of company tax to 20 per cent with the introduction of a CFT at 5 per cent would encourage medium size businesses (turnover from $50 million to $1 billion) to invest more, as many of these companies have domestic shareholders for whom the reduction in company rate is no benefit, as the shareholders pay tax on their personal marginal rates, which will not be affected.
- For businesses below $50 million turnover, the CFT could *increase* tax, despite the company tax rate cut from 25 to 20 per cent. Many of these companies have domestic shareholders whose tax paid on their current personal marginal rates will not be affected. Further, as most small companies provide services (or have very small assets bases), all their income tax profit will be subject to the cash flow tax. If so, they will receive no net tax cut, and could get a lower after-tax return if the CFT does not attract franking credits.
- The denial of interest expenses under the CFT (to prevent double dipping for full expensing) will increase the cost of financing as a source of investment, particularly for small businesses, who tend to fund capital investment by private financing (for example, by mortgaging their house or other personal property), rather than through capital raising or accumulated profit.
- Adding the CFT on top of existing arrangements (CIT and GST, both of which have similar, common elements) will add significant compliance costs for over one million companies, and those costs will be borne disproportionately by small companies.
  - The CFT will require companies to keep accounts with two sets of tax adjustments (one for CIT and one for CFT), in addition to normal accounting income for corporate

requirements. This complexity cannot be totally fixed by relying on information currently provided to the ATO.

- Adding a CFT for companies, but not other business 'entities' would create a further difference in taxation treatment between types of businesses. As many small and medium businesses can choose whether to conduct their operations through a company, trust, via a partnership or as a sole trader, any additional tax differences would simply be a recipe for tax planning for no economic benefit.

A simpler, less costly, more efficient, and more effective model to encourage investment by corporations would be to reduce the CIT rate for *all* companies to 25 per cent, and adopt targeted revenue raising measures *from within the corporate tax base* to comply with the Government's requirement of revenue neutrality. If there is concern that lowering the company rate might unnecessarily benefit highly profitable companies, such as miners and banks, that benefit could be offset by measures directed at them.

In broad terms, the Budget cost (approximately $8 billion in a full year) of reducing the company tax headline rate to 25 per cent could be recouped by:

- Reducing the concessionality of the *Diesel Fuel Rebate Scheme* for miners by about 50 per cent (raising around $4-$5 billion annually).
- Increasing the bank levy by 10 per cent (raising around $500 million annually).
- Cutting *Tax Expenditures* for corporations to raise the balance (approximately $2.5-$3.5 billion annually). This saving could be achieved by reducing the generosity of every tax expenditure by an amount, or targeting unwanted or outdated expenditures and removing them completely.

A 25 per cent company tax rate would:

- Reduce the cost of imported capital, in turn reducing the cost of capital for Australian firms.
- Harmonise the split headline company tax rates, eliminating the special rate for companies with passive income, and removing the difficulties caused by different franking rates.

This approach would promote investment without giving 'windfall gains' to companies regarded as obtaining economic rents in mining or banking. The resulting system would be closer to neutral (as between investment choices, investment vehicles and funding/financing sources), simpler to administer, significantly less costly for taxpayers and reduce opportunities for tax minimisation (compared to either the present arrangements, or the introduction of an added CFT regime). The reduction in tax expenditures would also improve Budget transparency.