A NEUTRAL ENTERPRISE TAX SYSTEM

by

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The 1975 Taxation Review Committee (Asprey) identified the need for tax reform in Australia, especially in regards to the taxation of company profits. Unfortunately, however, the options and analysis of the Committee was limited in scope. A neutral tax system for enterprise was not considered. A neutral tax system is one which treats the various legal structures of enterprises in the same way.

The tax treatment for co-operatives is the same but differs from that for companies. Corporate profits are taxed twice but this need not be so for co-operatives and trusts. The tax system is neutral both for co-operatives and trusts, financed by debt or equity. On the other hand the tax system heavily favours debt rather than equity with companies.

To ameliorate the problem of double taxation of corporate earnings the Asprey Committee recommended an imputation or credit system so that the individual is given credit for some or all of the tax already paid by the company on his dividends. This system is not neutral in regard to the legal structure of the enterprise. Nor is it neutral in regard to debt and equity sources of finance. If the imputation system is only partially applied then a division 7 tax problem would still remain. This problem becomes irrelevant to the neutral tax system which is applied to co-operatives and trust.

The neutral tax system does not discriminate between private and public companies.

In a neutral tax system the enterprise obtains a deduction to the extent it distributes its earnings. All enterprise tax can be avoided by paying out all earnings. Any need for more equity to finance growth is met by shareholders re-investing their dividends or through attracting new equity investors. The dividend payments could be expected to be considerably greater. This would increase the attractiveness of equity investment and the practicality of raising money through new share issues rather than by increasing liabilities. No significant change in dividend policy would be expected from the imputation system.

A comparison between the present 'separate', and proposed 'imputation' and 'neutral' systems of enterprise taxation are presented in the table below for the Australian economy 1978/79. This table has been based on the figures used in the submission* to the Prime Minister of June 1978 made by the Australian Associated Stock Exchanges.

The submission identified four main criticisms of the present 'separate' tax system of corporate profits. These were:

1. It discourages the payment of dividends.
2. It encourages companies to finance expansion from retained earnings.
3. It encourages companies to borrow rather than raise new equity capital, even if they are relatively highly geared.
4. It tends to divert personal savings, especially the savings of those on low incomes, away from equity investment and towards fixed income or property investment.

Compared with the neutral system, the imputation system is not likely to make any significant corrections to the first three problems. It could ameliorate the fourth problem as it would make the after tax income yield on corporate equities relatively more attractive then debt investments, unit trusts, and co-operatives. But it would do this more for the high rather than the low income earners.

The neutral tax system, in comparison, would create a strong pressure for correcting all four problems. In addition, it has the very important advantages not present in the imputation system of being neutral in regard to debt and equity financing and the legal form of the enterprise.

Because the impact of the neutral system can be expected to be much greater it would make a far greater beneficial impact on the securities industry and the economy. It would lead to a boom in new issues, rights

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trading, underwriting, and professional portfolio management. For the economy it would accelerate structural change with corporate re-investment decisions becoming subject to testing and acceptance in the stock market through the placement of new issues. The stock market would become really effective in performing the vital economic role of resource allocation.

Competition for new funds through new issues in the market place would produce a number of very valuable side effects. It should greatly improve the quantity and quality of corporate information as businesses compete for investor confidence for their survival and growth. Audit committees and other arrangements to improve self-regulation and investor confidence would develop as a result of market pressures.

Another advantage of the neutral tax system in comparison with the separate system is that it should provide more cash in the hands of shareholders. Lines 14 and 15 show this occurs when the dividend payout ratio increases to 75% which should be expected.

The neutral tax system would be one integral step towards a much more basic and profound reform in creating a cashflow tax system. This would remove the ambiguities between realised capital and trading profits and the problems of 26AAA and 26(a) of the Tax Act. These were also discussed in the Stock Exchange submission.

A cashflow tax system would be created from a neutral system by making all business cash expenditures, including those of a capital nature, a tax deduction. In this system there would be no tax deductions for depreciation and investment allowances but there would be a greater benefit of having all equity investment as a deduction. The deductions would operate on a similar basis to those that were available in some companies under section 77D of the Tax Act.

ASSUMPTIONS – (Made in Stock Exchange submission)

Line 1:— Pre-tax company income (before stock valuation adjustment), which was $7,718 million in 1976-77, will increase by 8 per cent in 1977-78 and by 15 per cent in 1978-79.

Line 4:— Company tax rates and allowances will remain unchanged. In 1977-78 the nominal tax rate of 46 per cent is likely to result in an effective rate of about 40 per cent after allowances for stock valuation adjustment and investment allowances. In 1978-79 we assume an effective tax rate of 42 per cent because of diminished investment allowances and a smaller stock valuation adjustment with lower inflation.

Line 8:— Dividend payments to individuals have risen from $624 million in 1973-74 to an estimated $680 million in 1976-77. Because of lower dividend payouts, and increasing ownership of shares by other than individual Australians (local and overseas financial institutions and companies) dividend payments to individuals have nevertheless fallen, as a percentage of company net income, from 21 per cent in 1973-74 to 17 per cent in 1975-76 and 15 per cent in 1976-77. We assume that introduction of imputation will, in the first year, stabilise the percentage payout to individuals at 15 per cent of company net income.*

Additional Note (Not included in Stock Exchange submission)

Line 16:— The individual tax rate is 47½% and a withholding tax at this level is collected with the neutral system by all companies on all dividends paid to all shareholders whatever their status. This provides a basis for tax credits as may be appropriate.

*Implicit in the figures is the fact that 30% of corporate dividends are received by individuals and 70% by other entities.

COMPARISON OF ENTERPRISE TAX SYSTEMS AUSTRALIA 1978-1979

LINE No.	TAX SYSTEM	*SEPARATE	*IMPUTATION	NEUTRAL		
	PROFIT PAID OUT AS DIVIDEND	50%	50%	50%	75%	100%
		$M	$M	$M	$M	$M
1	Est. company income before tax	9586	9586	9586	9586	9586
2	Deduction for dividend paid	Nil	Nil	2780	4170	9586
3	Taxable Income	9586	9586	6806	5416	Nil
4	Company tax (42% of line 3)	4026	4026	2859	2275	Nil
5	Profit after tax	5560	5560	3947	3141	Nil
6	Total dividends paid	2780	2780	2780	4170	9586
7	Profits retained	2780	2780	1167	3141	Nil
8	Dividends paid to individuals (15% of 6)	834	834	834	1251	876
9	Individual tax payable on dividends at 47½%	—	396	—	—	—
10	Imputed dividends of individuals (8 + 9)	—	1220	—	—	—
11	Individual tax (47½% of 10)	396	580	396	594	1366
12	Imputed tax credit 9	—	396	—	—	—
13	Net individual tax (10-11)	—	184	—	—	—
14	Cash to individual shareholders (8-13)	396	650	438	657	1510
15	Cash to corporate shareholders (6-8)	1946	1946	1946	2919	6710
16	Withholding tax on dividends (47½% of 15)	NA	NA	924	1387	3187
17	Total tax on company income (4+11+16)	4422	4210	4179	4255	4553
18	Cost to revenue	—	212	243	167	(131)
19	Total tax % pre-tax company income	46	44	44	44	47

* Source: Australian Stock Exchange's submission to the Prime Minister of June 1978.