Corporate Tax Cuts: Who needs them?

Treasurer Swan could reduce the headline corporate tax rate from its current 30 per cent rate to just over 15 per cent, with virtually no consequences for government tax revenue with one simple piece of legislation. Simply abolish the dividend imputation tax system!

Currently around half of company tax paid is offset by franking (tax) credits received by Australian shareholders in companies. Companies pay out around 70 per cent of after tax earnings as franked dividends and around 80 per cent of the attached franking credits are used by shareholders to reduce their tax payable.

If imputation were abolished, the company tax rate cut to around 16 per cent, and if (a big if) companies paid out the increase in after tax earnings as increased dividends the following effects would occur.

First, the headline corporate tax rate would be reduced – hooray! Second, shareholders would end up with the same after tax dividend income. Third, there would be minimal effects on budget tax revenues – other than some timing issues, and a relabeling of some corporate tax as personal/investor tax.

But the message from that is not that imputation should be abolished. Rather it is that business leaders and commentators simply refuse to acknowledge that the tax paid at the company level is not really all company tax.

And the 30 per cent headline rate is not at all comparable with similar rates in other countries with classical, or non-integrated, tax systems where company income distributed as dividends is taxed twice. If an appropriate comparison is made, which recognizes that company tax is really a withholding of investor level tax, our average "company" tax rate is closer to a classical system rate of 15 per cent.

To illustrate that our company tax rate is not high by international standards, consider the total government tax take on $100 of company income if the company has a 100 per cent payout ratio. Under the imputation system if the shareholder is a resident on a 45 per cent rate, total tax paid under our imputation tax system would be $45.

Under the classical tax system, company tax of $30 would be paid and the dividend payment of $70 would lead to a further $31.50 of tax for a shareholder on a 45 per cent tax rate, for a total tax take of $61.50.

Now while that is a hypothetical comparison which ignores overseas tax rate levels and other tax system features, it does indicate that focusing on the 30 per cent "headline" rate can lead to bad policy. And labeling the tax withheld as "corporate" tax rather than as a "withholding" tax on behalf of shareholders creates a misleading image when international comparisons are made.

Why do our business leaders not acknowledge the illusory nature of the 30 per cent headline rate? One reason may be that for some companies the headline rate is actually the true rate. For foreign shareholders, franking (tax) credits cannot be used, so that foreign companies may perceive Australia as having a higher than average corporate tax rate.

And for Australian companies with foreign shareholders, a cut in the headline rate would be advantageous to those shareholders. Whether that loss of tax revenue, but increased interest in Australian equity investments by foreigners would be a good outcome for Australia is an open question.

Another reason why business leaders have this myopic perspective may be that the imputation tax system induces them to act in ways which they would not otherwise do, but which are actually in the best interests of shareholders.

Imputation removes tax incentives for excessive leverage – at least for companies which are profitable. It also induces high dividend payout rates, thus reducing the ability of hubristic managers to retain earnings and invest in pet projects without having to face the discipline of raising outside funds.

Yes, we could almost halve the headline company tax rate without budgetary costs by abolishing imputation. But that is not an obviously good strategy – and would create significant angst among investors who have structured their investments around capture of franking credits.

Far simpler that we recognize the truth that a 30 per cent headline corporate tax rate under dividend imputation is actually nowhere near that large an impost on business.

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