

Corporate Income Tax in Context

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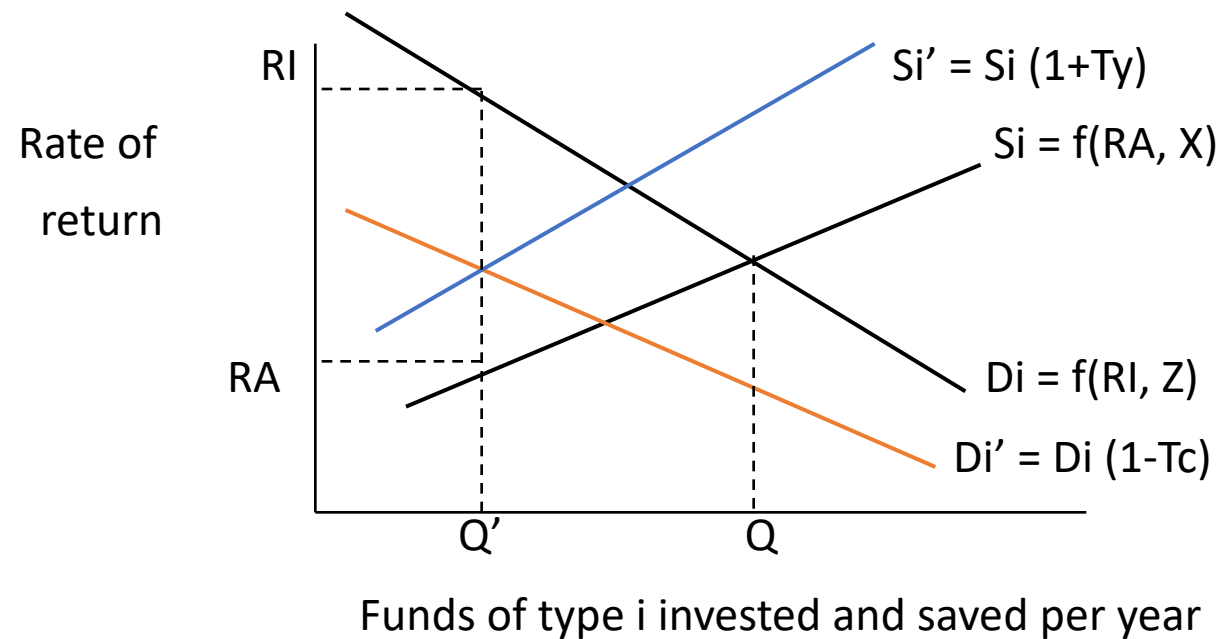
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Context and Key Results

- Corporate income paid by the investor plus income tax on interest, dividends and capital gains received by the saver determine the effective capital income tax wedge, $TW = RI - RS$
- The capital income tax wedge varies between imperfect substitution fund options, including
 - Debt and equity
 - Residents and non-residents
 - Dividends and retained earnings
 - Small and large businesses
- A lower corporate tax rate has different effects on both the absolute and relative magnitudes of the tax wedges for the different fund options

Income tax paid by company, T_c , and saver, T_y , for different fund options i , and tax wedge, $TW = RI - RA$



Company income tax base

Base = Revenue - Lab costs – Materials costs – Depreciation – Debt interest – Other taxes

- Residual return to equity to include
 - Normal return, plus
 - Above normal return for economic rents, market power, quasi-rents on above average firm management and technology
- Essentially a measure of consumer surplus for inframarginal investments
- Source base, nominal income measure

Saver income taxation on interest, dividends and realised capital gains

- Residents
 - Nominal income received
 - Resident base
 - Tax rates
 - Flat for super funds: 10% for capital gains; 15% for other
 - Individuals: progressive personal rate; 0.5 rate for capital gains > 12 months
- Non-residents
 - Nominal income received
 - A system of withholding taxes with rates set by bilateral tax treaties
 - Different flat rates for debt interest, franked dividends, unfranked dividends, capital gains

Effective tax rate: Debt

- Context
 - Represents an average of 40% of company funds
 - A deduction for corporate income tax
 - Taxed in hands of the saver. So shifts upwards saver supply curve by tax rate, T_y
 - Effective tax rate, $TW = RI - RS = T_y$
- Resident debt provider, T_y
 - Super fund: flat 15%
 - Individual: marginal personal rate
- Non-resident provider, T_y
 - Low withholding tax: average 3.5%

Effective tax rate: Resident equity

- Context
 - Equity about 60% of funds, most by retained earnings
- Resident shareholder
 - Dividends. Under imputation system, company tax is a pure withholding tax, and effective tax rate is income tax rate, T_y . Again, T_y given by
 - Flat 15% for super
 - Progressive personal rate for individuals
 - Retained earnings.
 - A form of double tax: (i) corporate income tax up to T_c , but generally less, plus (ii) second tax on shareholder realised capital gains or loss of value of nominal franking credit carried forward, but $< T_y$
 - Effective rate, T_W , may be $=$, $>$ or $< T_y$

Effective tax rate: Non-resident equity

- Context
 - Large public companies
 - With most countries using a territorial system no home country tax
- Dividends
 - Franked: corporate tax rate, T_c
 - Unfranked: withholding tax rate, generally $\leq 10\%$
- Retained earnings
 - Corporate tax up to company rate of T_c , but generally less
 - No additional withholding tax on realised capital gains
- Note: wide range of effective tax wedges

Small Vs large companies: effective tax rates

- Key differences
 - Small companies, including family owned and operated, and wholly dependent on resident funds, account for about a half of company activity
 - Effective tax rate: T_d for debt and dividends; form of double tax for retained earnings
 - Large and public listed companies with access to non-resident funds. For many, arguably non-residents are marginal funders and Australia is a price taker in a large global market
 - Tax treatment and effective tax rate varies from: very low for debt; through to T_c for franked dividends
- Generally, small and large companies are imperfect substitutes (e.g. different attributes on scale economies, coordination and TW combined with portfolio preferences), and sometimes complements

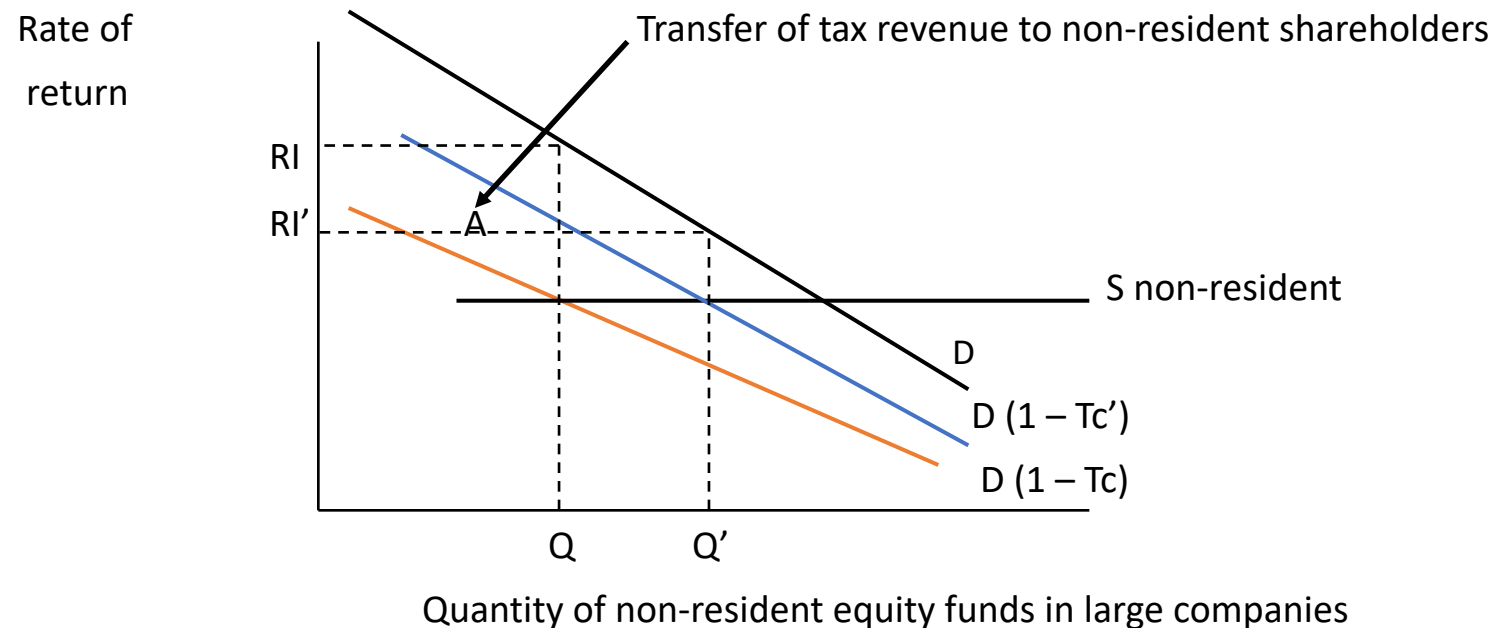
Effects of a lower corporate tax rate on effective tax rates, incentives to invest, and redistribution: Small companies with resident only funders

- No change. Effective tax rate remains at T_y for
 - Debt funds
 - Franked and unfranked dividends. Lower corporate rate fully offset by more tax collected on saver or smaller refund
- For retained earnings. Represent on average about 12% of current fund mix
 - First-round benefit of lower corporate rate, ΔT_c
 - Partly recovered in the future with higher realised capital gain and/or smaller present value of franking credits carried forward

Effects of a lower corporate tax rate on effective tax rates, incentives to invest, and redistribution: Large companies with marginal non-resident funders

- Effective tax rates
 - No changes to withholding taxes and effective tax rate for
 - Debt
 - Unfranked dividends
 - Dollar for dollar lower effective tax rate for
 - Franked dividends
 - Retained earnings
- Effects on decisions and economy include
 - A stimulus to investment, GDP and labour remuneration
 - Both a short term and a long term transfer of revenue from Australia to non-residents on both normal and above normal returns on inframarginal investments
 - Much smaller increase in GNI, and likely a negative effect

Lower company tax rate, T_c' , effects on non-resident equity investment in large companies



Bottom line

- In studying the effects of corporate income taxes and reform options (including tax system, base or rate) need to disaggregate effects for at least different imperfect substitute fund options
 - Debt and equity
 - Resident and non-resident suppliers of funds
 - Retained and distributed earnings
 - And associated differences between small and large companies, and mixes across industries
- As a result:
 - different effective tax rates on different imperfect substitute fund options
 - reform options have different effects on the absolute and relative magnitudes of effective tax rates on the different options