Review of Business Taxation: A Platform for Consultation

BACKGROUND

This submission deals with the taxation of companies and trusts.

The Committee, in advocating a level playing field, said: "It does not make sense for exactly the same investment to attract very different tax treatment simply because it is put through a trust rather than a company. Such a result violates the tax principle that taxpayers in similar positions should be treated similarly."

From this logical starting point the Committee then went on to suggest that trusts should be taxed as though they were companies – a view already favoured by the Government and the Taxation Commissioner.

A BETTER APPROACH

However, it would be much more equitable to eliminate the present anomalies by reforming the system the other way round. Companies should be taxed as though they were trusts.

The gun lobby has a political slogan on the lines of "guns don't kill people, only people kill people". In the tax area an appropriate slogan might well be "companies don't pay taxes, only people pay taxes".

The reality is that any taxes nominally imposed on a corporate entity are ultimately borne by individuals - either shareholders or customers. Those commentators who for philosophical reasons from time to time urge higher taxes on businesses invariably miss this important point.

Companies are not actual "persons", except by way of legal fiction. Wealth is really owned only by human beings, either directly or indirectly.

Clearly, all the profits of a company, whether distributed or not, morally and economically "belong" to the shareholders. In the context of the type of sliding scale income tax system being used in this country such profits should accordingly be taxed in the hands of individual shareholders at their marginal rates.

One easy way of doing this would be to apply the current rules applying to trusts also to companies, thus removing the anomalies in the present system, as well as greatly simplifying it. There would be much greater transparency and confusing expressions such as "imputation credits" could disappear from the vocabulary.

The odd concept of a major company asset which has to be recorded on paper but which cannot be included as an item in a company balance sheet, the franking account balance, would then disappear.

THE INTENTION OF PARLIAMENT

In line with the present principles applying to trusts any accounting profit earned by a company which was outside the definition of taxable income could be passed on to the shareholders as a tax-free distribution instead of losing its status and becoming an unfranked dividend which is then taxable in the hands of its recipients.

Thus any tax concessions intended by Parliament to apply to individuals in respect of their own direct income would apply, as in logic they should, also to income flowing to them indirectly via a company. Examples of this would be capital gains within the indexation component and the building allowance. The same principle would also cover amounts arising from the revaluation of assets.

The intriguing question emerges as to why this simple way of eliminating the previous quite unfair double taxation of company profits was not enacted in the first place, even if revenue considerations might have required some tinkering with the tax rates.

AN ALTERNATIVE APPROACH

Another way of taxing corporate earnings in the hands of shareholders would be to treat companies as though they were partnerships – as indeed in an economic sense they are.

This would be even fairer than using the trust approach, as it would allow the benefit of any tax losses to be passed on to the shareholders at the time the losses are incurred.

EQUITY

Either of the above reforms would also automatically deal with another inequity of the present dividend imputation regime – a problem of which both the Government and the Committee are aware - namely, that any excess imputation credits that cannot be used in any income year are lost.

There is no refund mechanism in place, even though tax has already been paid on the relevant income in the hands of the company. This disadvantages low income shareholders, including self-funded retirees, whose marginal tax rates are lower than the company tax rate. These effectively face the company tax rate on all dividend income, rather than their own marginal tax rates.

A reform on the above lines would also remove any incentive for Australian companies to relocate themselves overseas.

PAYE ASPECTS

If the Government wanted to collect its revenue concurrently with the actual payment of dividends then this could readily be accommodated through a system of group certificates or their electronic equivalent.

A simple approach would be to deduct tax at, say, 20 per cent for all shareholders who supply a tax file number and at the top marginal rate in the system (currently 48.5 per cent) for those who do not.

The 20 per cent instalments could then be allowed for automatically at the time of assessment, in the same way as are PAYE deductions made from salaries and wages.

If desired, a right for pensioners and other low income recipients to have the standard rate of deductions varied could be built into the system.

A number of variations to this theme are also possible. For example, undistributed profits could be treated in several different ways:

* The company could make no tax payments to the tax office, and merely notify shareholders of the amount to be included in their own tax returns - the equivalent of a partnership retaining profits within the business. This could cause cash flow problems for some persons, as investors would be up for tax on earnings which they have not received in cash - although there are precedents for this in other situations.

* The company could deduct group tax in the same way as suggested above for distributed profits.

* The company could deduct tax at the 48.5 per cent top marginal rate in the system, but this time as a final tax instead of as an advance payment. If the company subsequently wanted to distribute the remaining 51.5 per cent then this would naturally be regarded as an exempt dividend.

ECONOMIC ASPECTS

However, the opportunity could also be taken to forcefully encourage companies to distribute to the hilt for economic rather than pure tax reasons. This could, for example, be done by imposing an undistributed profits tax at an even higher rate than 48.5 cents in the dollar - say, at 66 cents in the dollar, which is the penal rate applied to the income of minors.

Companies sometimes regard profits retained in the business as a source of cheap capital. It would be healthier for the nation and it would lead to a better allocation of resources if there were a requirement that all profits had in the first instance to be paid out to the shareholders to whom they morally belong.

These could then make their own investment decision as to whether to put the money back into the same company or to deploy it elsewhere. Any company wanting extra capital should have to justify this to the market, instead of just passively and paternalistically hanging on to the plough-back.

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