Should Dividend Imputation make us rethink Company Tax Cuts

With ideology driving the corporate tax debate, one important fact crucial to informing policy gets consistently ignored. Australia has a dividend imputation tax system.

Consequently, if (and that where the important issues arise) companies distribute all earnings as dividends to Australian investors, the level of company tax rate is irrelevant. The income generated by a company is taxed in total at the dividend recipient investor's tax rate. The company tax rate merely determines how much of the same total tax take is paid at the company level or the investor level.

So, why the (often confused) debate about the supposed importance of the level of the company tax rate. Of course, it's because the "if" condition doesn't hold, but recognising the ways in which that applies helps us to understand what the critical issues are.

Importantly, those issues differ depending upon what type of company is being considered. Different considerations are relevant for foreign owned versus Australian public versus Australian private companies.

Consider, first, foreign owned companies. The corporate tax rate matters to them because they do not get the benefits of imputation. Reducing the rate would be a boon to such companies operating in Australia, and any less tax paid would be at the expense of Australian government tax revenues.

Is that a good reason for reducing the company tax rate? Arguably it could be if the 30 per cent rate acted as a deterrent to foreign companies establishing subsidiaries in Australia and contributing to economic growth and welfare.

But it would be nice to have some hard evidence on that score. It is not obvious that Australia is underweight internationally in terms of foreign company presence. And many foreign companies find ways to reduce Australian company tax payments via, for example: parents providing funding via debt rather than equity (subject to thin capitalisation rules); profit shifting via transfer pricing techniques; exploiting stapled security structures effectively involving business trusts.

For Australian public companies, many executives and boards appear to focus on the private benefits to them rather than implications to shareholders. Specifically, a cut in the tax rate combined with no change in the size of dividend payments would leave management with more free cash flow under their control. Favoured projects can be pursued without needing to face the test of capital market investors through having to raise funds externally.

It is true that there may be higher transactions costs involved in raising external funds, rather than retaining earnings. But, particularly with modern electronic technology, it is not clear those outweigh the agency costs of management having access to free cash flow. Companies could distribute all earnings and offer attractive dividend reinvestment terms or make rights issues of shares if there are valuable investment opportunities available to pursue.

And it must not be forgotten that a lower company tax rate means shareholders receive less franking credits, such that an unchanged level of cash dividend means less after-tax income for the shareholder. If management focuses on shareholder value, it would presumably increase the level of dividend following a company tax cut, thereby negating any impact on retained earnings!

One caveat should, however be entered – although it does not necessarily constitute a case for lowering the company tax rate. Foreign shareholders in Australian companies will benefit (either from higher cash dividends or retained earnings which generate capital gains).

Finally, consider private companies. Many of these will not pay out all earnings as franked dividends because controlling shareholders have marginal tax rates above the company tax rate.

Retaining cash in the company has tax advantages for such shareholders because distribution to high tax rate investors would require a current payment of personal tax (even after allowing for use of franking credits). Far better to defer or avoid tax at the personal level while on high marginal tax rates, and obtain benefits from earnings retention that hopefully increases the value of the company and which can be realised later at concessional capital gains tax rates.

So, for these smaller companies (central to the current debate) a lower rate of company tax matters because it leaves them with higher free cash flow in the company. But that benefit arises because the shareholders are avoiding, or postponing, full payment of tax on the company income at their personal tax rate. That is a benefit which is not available to sole traders or partnerships which also do not get the benefit of limited liability.

It is not obvious, at least on distributional grounds, that assisting high income business owners to further reduce total tax bills on corporate income by cutting the company tax rate is a good policy. Perhaps, instead, it would be worth considering a full attribution model for private companies, in which shareholders are credited for tax purposes with all of a company's income, regardless of whether it is distributed or not, and get the offsetting tax credits for company tax paid.

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3 July 2018