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Replacing Corporate Income Tax with a Cash Flow Tax Tied to High Priority Affordable Housing

Key points

- ISA endorses the NSW Review of Federal Financial Relations ('the Review') broad-brush approach to tax reform especially examining the rational structure of taxes and overall fiscal relations.
  - Recent Australian experience suggests that tax reform processes are more likely to be successful if the wins and losses broadly cancel out.
- ISA's submission to the Review is limited to consideration of a single federal tax reform – replacing the corporate income tax with a cash flow tax and also how this initiative could be linked to the supply of high priority affordable housing.
- A cash flow tax is identical to company tax in record keeping terms. However, it allows an upfront deduction of capital expenditures and disallows transactions related to interest, depreciation and related party payments (charges for intellectual property).
- A cash flow tax would:
  - encourage more real business investment (funded via equity) upfront and over time;
  - mitigate the problem of multinational corporations shifting profits offshore;
  - leave most Australian businesses (that achieve normal rates of return) with a zero-tax liability over time – only firms earning economic rents would pay the cash flow tax; and
  - achieve the most appropriate assignment between risk and reward required by tax principles, incentivising entrepreneurship and private equity ventures and discouraging the branch office culture and destabilising use of foreign leverage.
- Companies would be able to trade their tax losses on an open market and/or carry them forward at the long-term government bond rate to offset against future profits.
- To garner support for the reform, the Federal Treasurer could link a share of tradeable tax losses (credits) to fund States' waiting lists for high priority affordable housing.
  - Tradeable tax losses or credits could be deployed by community housing developers who would exchange tax credits for equity funding for affordable housing projects. This

is the fast, efficient and international proven way to rapidly inject equity into the sector and curb the growth and public costs of homelessness which is expanding at an alarming rate.

Background

ISA's Deputy Chair, The Hon. Peter Collins AM QC and Chief Economist, Mr. Stephen Anthony met with The Hon. Dominic Perrottet, Treasurer of NSW on 23 October 2019. Mr. Perrottet invited ISA to make a submission to the *NSW Review of Federal Financial Relations ('the Review').* At the end of the meeting the NSW Treasurer asked ISA for a full explanation of the benefits of the Garnaut *et al.* 2018 proposal for a cash flow tax reform to replace the company tax.[1] Also, and an explanation of how the tax reform could be linked to raising the supply of high priority affordable housing in NSW and more broadly.

As part of the *Review*, NSW is looking at the structure of Commonwealth-State finances and how to improve existing arrangements. In the process, the State is looking for strategies that would replace existing inefficient and volatile revenue heads with more efficient and stable options. The *Review* also extends into the structure of Commonwealth taxes such as corporate income taxation.

ISA supports the *Review's* principles-based approach and broad scope. Thought leadership and reform is never easy. We also note there are benefits in making the reform process as broad as possible (by including as many other governments that will come to the party). The idea is to spread the gains and losses from the reform process as widely as possible so that what is lost on one measure is gained on another, so that on balance, people feel no worse off and in fact perceive benefits from efficiency. Here the Federal Government can play an important role by incentivising the States' promotion of a more rational and streamlined mix of taxation and helping to better balance revenue and spending shares at each level of government.

The cash flow tax

The Garnaut *et al.* 2018 cash flow proposal is designed to mitigate the problem of multinationals offshoring profits to overseas tax havens and the outsourcing of jobs and investment. Currently, many Australian resident but foreign owned, 'branch offices' are paying their overseas head office 'service fees' designed to shift profits offshore and bring down their tax payables. The cash flow tax reform is designed to deal with the problem directly by only allowing firms to claim a deduction on what they 'spend' here in Australia and 'now' – in each time period.

- The reform is administratively simple as it requires no changes to data collection compared to the existing corporate income tax.

[1] Garnaut R., Emerson, C., Finighan, R. & Anthony, S. 2018, 'Replacing Corporate Income Tax with a Cash Flow Tax', *Melbourne Economic Forum*, December 2018.

- The reform allows for the upfront write-off of capital, paid for by disallowing (net) interest expenses, depreciation and related party payments that are not truly arm's length.
- The reform would boost investment in new productive assets in Australia in the short and longer term. It would provide immediate fiscal stimulus and enhance deployment of a deeper technology embodied capital stock over time.
- Companies incurring a loss would be allowed to trade tax credits (certified by the ATO) with companies making a taxable profit on an open market.
  - Alternatively, they could carry forward their losses at the long-term government bond rate to offset against future profits.
- Most enterprises would be zero-taxed over time – except those earning economic rents – because all businesses (large and small) would be able to write-off their capital purchases upfront and carry forward losses.
- Reframing the focus of business taxation onto equity investment is consistent with legal principles which seek to match risk taking activity and tax deductibility. The cash flow reform smiles upon entrepreneurial activity and should act as an incubator to private equity.
- Importantly, the cash flow tax proposal directly addresses structural imbalances and economic malaise that has beset OECD economies. These include low productivity, increasing concentration in key sectors such as IT, finance etc., which are stifling competition and even innovation more broadly across the global economy.

For non-financial companies, removing the deductibility of net interest payments would have the systemic benefit of removing the bias towards debt funding as incentivised under the current tax system. Consequently, this would likely reduce corporate indebtedness overall, with the ancillary benefit for greater overall financial efficiency and stability.

For financial institutions (banks), Garnaut *et al.* 2018 proposed a modified version of the corporate income tax – the Financial Sector Income Tax (FSIT). Here taxable income will still include interest revenue and expense components, whilst maintaining the immediate deductibility of capital expenditures.

- Importantly, the successful implementation of this scheme requires the establishment of clear boundaries between financial institutions (banks) and non-financial (lending) companies, to prevent the latter claiming interest deductions by default.

Garnaut *et al.* 2018 proposed a gradual transition scheme that would ensure a smooth transition from the current company tax towards the new cash flow tax. For the transition period, they proposed a gradual 'phase-in' of the cash flow tax over 10-years for companies not wanting to switch immediately. Companies also have the choice to make an irrevocable switch to the cash flow tax at the time of their choosing, perhaps to take advantage of the immediate upfront capital expenditure deduction.

The present activities of certain large multinational companies are drawing significant 'value' away from the Australia economy whilst contributing very little directly in terms of employment and company taxes. The mentality here is that of the 'branch office' subsidised by cheap foreign debt. The playing field for these firms compared to those that are Australian owned is uneven. They have obtained a competitive advantage through lax tax policy and tax administration. This situation is intolerable and cannot continue unabated.

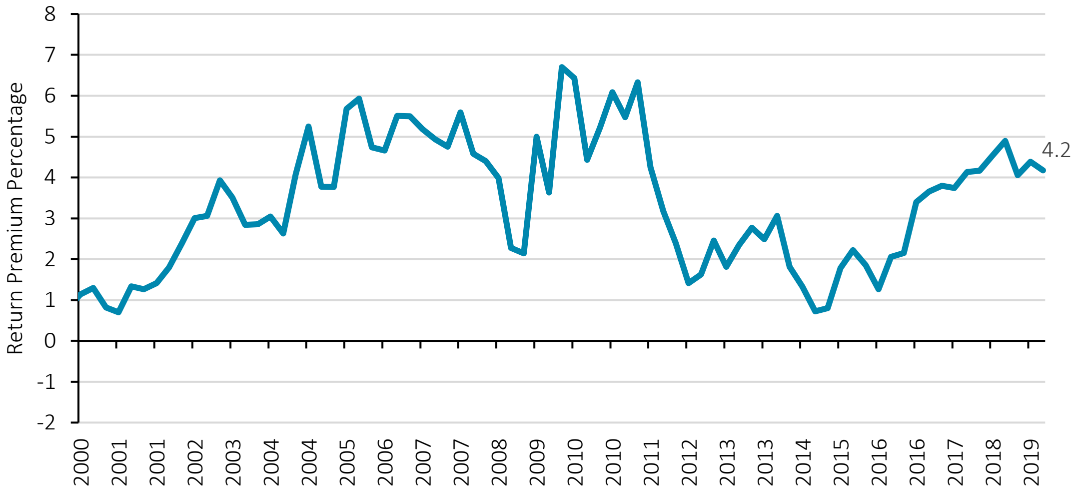
The outcome for the Australian economy is to promote entrepreneurship and financial solvency via a cash flow tax reform. It seems to ISA, that part of the reason why so little technical innovation is occurring in Australia relative to comparable small open economies like the Scandinavian nations or Canada is linked to tax policy measures which prefer foreign multinational business models and the use of debt over Australian owned businesses and the use of equity.

Revenue potential

The proclivity of Australian businesses with foreign owners to 'offshore' profit is evident from a routine inspection of ABS Balance of Payments 5302.0. The data reveals persistently higher rates of return on Foreign Direct Investment (FDI) equity holdings of foreigners' relative to Australian holdings overseas.

- Net Income flows in the Balance of Payments reveal a structural 'return premium' favouring inward FDI versus outward FDI, see Figure 1. Global market capital flows and arbitrate are supposed to remove these opportunities unless they are driven by institutional factors such as the structure of taxation.

Figure 1 – FDI return premium (return of FDI liabilities *less* FDI assets)

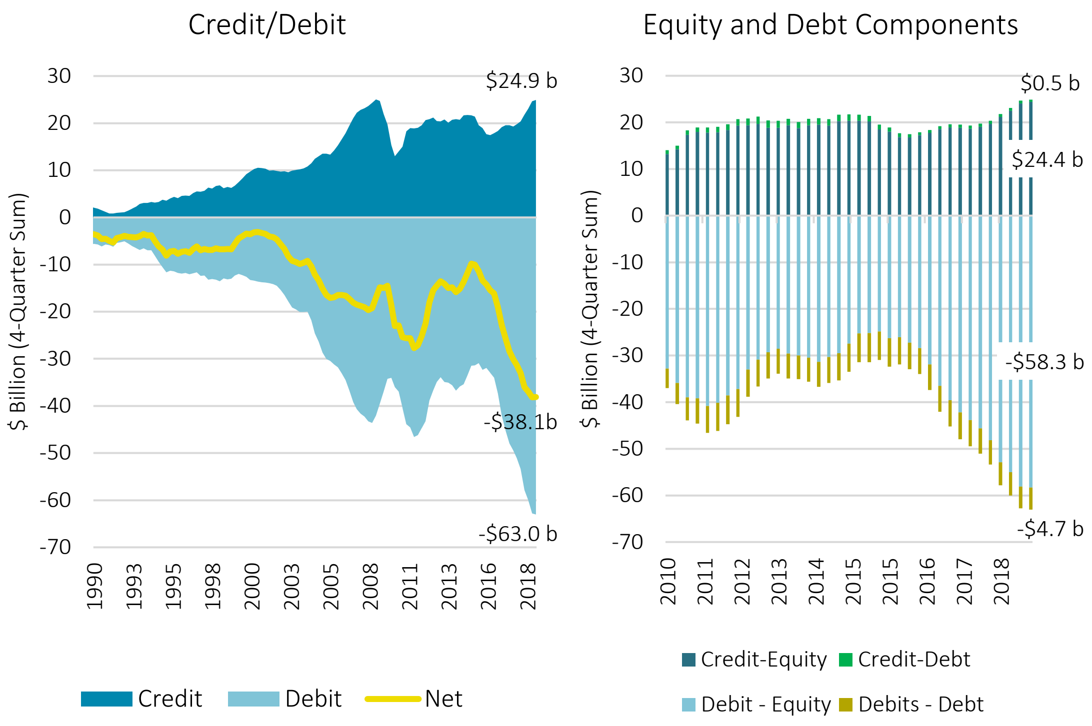


Source: ABS Cat.5302.0

The FDI return premium in 2019 is around 420-basis points after being persistently high for two decades. It does seem to be attributable to foreigners use of tax structures as promoted by Big-4 accounting firms, including accessing cheap debt offshore.

- Even though the stock FDI equity investment held by Australians and foreigners is broadly equal, the net income flows on direct investments in equity assets is skewed towards net outflows as shown in Figure 2.

Figure 2 – FDI credit vs debit



Source: ABS Cat.5302.0

The current annualised FDI debit flow in June 2019 of $58 billion – grossing this up for tax paid – represents a crude estimate of the base broadening potential of the cash flow reform. Some part of this $58 billion – plus taxes paid added back - represents the potential annual transfer that is available from foreigners generated by the cash flow reform.

Costing

ISA has costed the likely revenue impact of the introduction of a cash flow tax, gradually replacing the company tax. To do this we have sourced publicly available taxation statistics from the ATO and applied a tops-down, aggregate approach treating these as one large company.[2] Our modelling of tax revenue estimates is based on the following.

[2] Conducting the costing - estimation work using the aggregate statistics published by the ATO and assuming a single firm is clearly technically incorrect due to the presence of net losses in the aggregate data. ISA should not technically assume that these losses revert to income as part of our single taxpayer approach. Our justification is the unreasonableness of the published aggregate ATO International Dealings Schedule outcomes which sum to multibillion losses each year as summarised in the table below. It is difficult to understand how these losses can be generated on overseas activities, year-after-year, for activities which we are shown previously to be very profitable.

	2012-13	2013-14	2014-15	2015-16	2016-17
Revenue less expenditure ($m)	-142,824	-127,980	-157,695	-193,239	-110,095

- A 10-year gradual transition scheme.
- A tax rate of 30 per cent.
- Allowing financial institutions unchanged treatment of interest revenue and expense.
- Estimating a 'deterrence effect' associated with the recently introduced Diverted Profits Tax (DPT)[3].
- Transitioning from the company tax (30 per cent) by 3 per cent per year over 10 years while ramping up the cash flow tax (30 per cent) at the same rate over this period.

Under this gradual transition, ISA's latest estimate, shows that by the end of the 10-year transition period when the cash flow tax is fully operational, government tax revenue will rise by $3.9 billion, in the last year, relative to the existing company tax (see Table 1). We feel this estimate is likely to be conservative:

- It does not capture the ongoing compliance gains from ATO clamping down on significant global entities with international transactions, nor does it account for the 'on-shoring' of economic activity.
- It does not capture the dynamic efficiency gains from higher CAPEX, capital deepening and associated technology related productivity gains.
- It does not capture the incentive effects associated with greater equity investment –as Australia's economy becomes an equity incubator and head office rather than a branch office at the whim of multinational foreign-owned corporations.

To the extent that our estimate understates the revenue gains from introducing a cash flow tax, there may be scope to reduce the 30 per cent tax rate faced by most larger companies.

The cash flow tax transition will be stimulatory to the Australian economy over the first five years of the transition. Certainly, the development of a market in the tradeable tax losses in Australia would be unlock dynamic gains for Australian owned corporations at it has in the United States. The reform could be introduced as part of a stimulus package that brings forward of business investment and infrastructure projects.

ISA projects that the cash flow tax transition will be revenue neutral by Year Nine, with a noticeable upswing starting from Year Five.

[3] The ATO recognised multi-national companies may not be paying the appropriate amount of tax given their significant economic activity in Australia. New laws introduced such as the Diverted Profits Tax (DPT) (came into effect on 1 July 2017) aim to ensure significant global entities pay tax for their economic gains in Australia. The application of the DPT tax depends on the assessment of the risk of non-compliance.

Table 1 – Projected tax revenues under company tax and cash flow tax schemes during the 10-year transition period

		2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30
Company tax modelling	*$b*	99.5	102.1	104.7	110.2	114.9	119.8	124.9	130.2	135.8	141.6
Cash flow tax modelling FSIT (Bank exempt)	*$b*	90.9	93.3	96.7	101.9	108.4	115.2	122.3	129.7	137.5	145.6
Total revenue from *transitional scheme* FSIT (Bank exempt)	***$b***	**98.7**	**100.3**	**102.3**	**106.9**	**111.6**	**117.0**	**123.1**	**129.8**	**137.3**	**145.6**

Source: ISA Analysis, ATO Taxation Statistics, Budget Paper No.1 (2016-17, 2017-18, 2018-19 & 2019-20).

Affordable housing

Base broadening reform and the establishment of tradable tax credits under the cash flow tax opens potentially new funding channels for the delivery of critical social infrastructure like affordable housing. NSW (like most Australian states) has a significant shortage of affordable rental housing based on a high priority waiting list of around 5,000 out of a larger social housing waiting list of about 60,000 households. At the same time Census data points to geometric growth in the rate of homelessness. Further, the 'missing middle' of key public safety, health, education and care workers who have difficulty accessing the private rental markets in the areas where they work has driven disproportionate commute times and pressure on roads and transport services.

This affordable housing supply gap will increase for the foreseeable future unless decisive policy and funding actions are taken to address the intergenerational equity issues that emerge around homeless and other disadvantaged families, especially those with children. Without a pipeline of adequate affordable rental supply to bridge the gap between the social and private rental tenures, mobility toward independence will continue to be frustrated.

The affordable housing sector currently is unable to access the scale of equity capital needed to address this shortage. This is evidenced by market failure in the documented under provision of below-market rental housing despite overwhelming demand. Affordable rental housing does enjoy access to shorter term debt issuance through the newly established National Housing Finance and Investment Corporation (NHFIC)certainly does not have equity funding base for any material expansion.

To bridge this funding gap, policy must deliver the necessary equity capital injection to affordable housing providers. ISA believes a targeted tradeable tax credit that allows institutional investors to provide direct equity funding to community housing developers would be mutually beneficial for both parties and would seed a self-sustaining stream of institutional investment into the affordable housing sector. The affordable housing tax credit would work as follows:

- Accredited/government regulated community housing developers would be provided with contestably allocated tax credits from the government upon the successful tendering of an affordable housing construction project.
- These tax credits would then be sold to institutional investors with long-term investment horizon in exchange for equity funding.
  - Equity is a critical part of affordable housing development funding mix as relying on bank/NHFIC term lending alone is not commercially viable. (The cashflow generated by the rental dwellings can only support debt equal to approximately one third of build cost).
  - Through the purchase of tax credits, institutional investors would become a passive participant in the affordable housing development project. They would be mandated by Federal or State authorities to ensure projects are delivered as promised in terms of affordability, quality and quantity.[4] Their risk would be mitigated by the regulation of the non-profit community housing industry.
  - The key appeal to institutional investors would be the use of tax credits to reduce their tax liabilities, while not having to maintain an ongoing equity stake in the affordable housing asset class – they can write-off these higher risk investments on the successful delivery of projects.

Over time, market equilibrium should see the tax credits trade at close to face value as they have overseas. The credit-efficiency goal would be to ensure that 90 per cent of tax credits go directly to affordable housing investments.

The program would need to be regulated via a statutory body to eliminate fraud and waste, ensuring the scheme generates self-perpetuating funding towards the construction of affordable housing.

The program over time is likely to become self-sustaining, as community housing providers build up their balance sheets and can then develop their own large scale affordable-housing developments as community resources.

By embedding the affordable housing tax credit into the Income Tax Assessment Act, the scheme would serve to demonstrate how the alignment of policies and incentives could deliver benefits on multiple fronts – an enhanced supply of affordable housing (funded via higher levels of equity funding relative to debt) and lower taxes for institutional investors to incentivise their knowledge stewardship and intellectual property contribution to the policy.

[4] Upon the completion of construction, investors will entrust the management and maintenance of the housing developments to qualified community-housing entities.

Has a viable tax-credit scheme operated anywhere else in the world? The United States' low-income housing tax credit program generated three million units from 1987 to 2015 in 45,900 projects and continues to this day, being made permanent in 1993. It now creates about 110,000 units a year with a total worth of about $US8 billion a year. Operators achieved a 97.8 per cent occupancy rate in 2016 and a 0.7 per cent cumulative foreclosure rate. The scheme has a long, successful pedigree and high corporate investor confidence.

In summary

Replacing the existing corporate income tax with the cash flow tax would ensure the tax burden is distributed more equally amongst all participants that have benefited economically from this country. It is designed to ensure:

- Multinational companies pay their fair-share of taxes and stop the off-shoring of local jobs;
- More domestic investment through the immediate CAPEX deduction;
- Incentivising efficiency and productivity gains through local R&D – funded by equity rather than debt; and
- Tax losses are tradeable via the exchange of tax credit, with the potential deployment of some of these credits towards building more affordable housing.

Please contact me if you have any questions in relation to this submission.

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