A DUAL INCOME TAX SYSTEM FOR AUSTRALIAN SMALL BUSINESS: ACHIEVING GREATER TAX NEUTRALITY?

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Abstract

This article explores the notion of tax neutrality and its relationship to the taxation of business structures, especially for Australian small businesses. In particular, it analyses whether the introduction of a dual income tax (DIT) system, as advocated by Pitcher Partners could achieve this. It will be argued that a DIT does have the potential to improve tax neutrality and may remove business structural biases that exist in Australia. Furthermore, it will be argued that steps towards tax neutrality would be likely to be achieved through greater alignment of the individual marginal tax rates and that with businesses.

Key words: dual income tax, tax neutrality, small business, tax reform, Australia.

I. INTRODUCTION

In Australia, it appears that every newly elected government grapples with how best to tax small businesses. The small business sector is often seen as requiring special tax needs, with lobbying made on their behalf for special relief and concessions to compensate for their disadvantages due to their size and/or inherent characteristics.[1] However, these changes and concessions may lead to adverse consequences, in particular increased complexity. This means that any proposals for reforms need careful analysis.

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[1] For example, it has been reported that how small businesses can struggle with their cash flow: Melissa Belle Isle, Brett Freudenberg and Richard Copp, 'Cash Flow Benefit From GST: Is It Realised by Small Businesses in Australia?' (2014) 29(3) *Australian Tax Forum* 417; capacity to comply with regulations: Brett Freudenberg, 'Lifting the Veil on Foreign Tax Flow-through Companies: Could Australian Closely Held Business Benefit From their Governance Regimes?' (2013) 28(3) *Australian Journal of Corporate Law* 201; complexity: Brett Freudenberg et al, 'A Comparative Analysis of Tax Advisers' Perception of Small Business Tax Law Complexity: United States, Australia and New Zealand' (2012) 27(4) *Australian Tax Forum* 677; and compliance cost: Phil Lignier, Chris Evans and Binh Tran-Nam, 'Tangled up in Tape: The Continuing Tax Compliance Plight of the Small and Medium Enterprise Business Sector' (2014) 29(2) *Australian Tax Forum* 217.

It is understandable why governments would focus on small businesses as they can contribute significantly to the economy. In 2016–2017, there were 2,085,729 small businesses (with an annual turnover of less than $2m) representing 98% of businesses in Australia.[2] They can provide job opportunities within the community in which they operate, thereby stimulating the community's economic growth.[3] Though many small businesses are non-employing,[4] they do account for approximately 93% of employing businesses at the end of 2016-17[5] , with 45% of nonfinancial private sector employment and approximately 33% of Gross Domestic Product (GDP) during 2014–15.[6] Australia is not unique, and small business is recognised internationally as contributing to a significant portion of the world economy.[7]

It should be noted that determining what a 'small' business is can be problematic, as generally a variety of qualitative and/or quantitative measures can be used. In terms of qualitative, a small business can be one that is held, managed and financed by one or several individuals.[8] This means that owners can be solely responsible for decision making and the invested capital in the business. Alternatively, small businesses can be classified according to such things as turnover, assets and employment. [9] For example, the Australian Bureau of Statistics (ABS) defines a small business as a business employing fewer than 20 fulltime equivalent employees;[10] with the Australian Taxation Office (ATO) defining small business for statistical reporting purposes as an entity with annual turnover of less than $10 million.[11] For the purpose of this study a small business is one with an annual turnover of less than $10 million and less than 20 employees.

In 2015, Pitcher Partners advocated for a dual income tax (DIT) system to be introduced in Australia for small businesses.[12] Such a system had been put forward earlier in the Henry Tax Consultation paper to address structural issues.[13] In the Henry Review, it was stated that Australia should consider moving the company income tax system to a broader-based DIT

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[2] Australian Bureau of Statistics, *Counts of Australian Businesses, including Entries and Exits*, Jun 2013 to Jun 2017, 8165.0 (ABS, 2018).

[3] Commissioner Greg Tanzer, 'COSBOA Conference- What is ASIC doing to help small business?' (speech delivered at the Council of Small Business Australia (COSBOA) Conference, Sydney, 17 July 2015).

[4] There were approximately 61% of non-employing small businesses at the end of 2016-17: Australian Bureau of Statistics, above n 2.

[5] Ibid.

[6] Australian Government - Australian Small Business and Family Enterprise Ombudsman, Small business counts: small business in the Australian economy, (2016).

[7] Ann Hansford, John Hasseldine and Carole Howorth, 'Factors Affecting the Costs of UK VAT Compliance for Small and Medium-sized Enterprises' (2003) 21(4) *Environment and Planning C: Government and Policy* 479.

[8] Brett Freudenberg, 'Tax Transparent Companies: Striving for Tax Neutrality? A Legal International Comparative Study of Tax Transparent Companies and their Potential Application for Australian Closely Held Businesses' (PhD Thesis, Griffith University, 2009) Ch 2.

[9] Scott Holmes and Brian Gibson, 'Definition of Small Business, (Final report, University of Newcastle, 5 April 2001); Small Business Deregulation Task Force, *Time for Business* (AGPS, 1996), 19.

[10] Australian Bureau of Statistics, above n 2.

[11] Australian Taxation Office, *Taxation statistics 2012–13* (ATO, 2015); Hansford, Hasseldine and Howorth, above n 7. Note in the Australian tax legislation can use different measures to determine whether a business is small, such as the turnover test and the CGT asset test.

[12] Alexis Kokkinos and Theo Sakell, 'The Importance of the Middle Market' (Tax Discussion Paper, Pitcher Partners Advisor Proprietary, 24 July 2015).

[13] Ken Henry, *Australia's Future Tax System: Report to the Treasurer (The Henry Review)*, Final Report (2009).

which includes dividends and greater use of accrued recognition to measure savings income. Such a move could provide a greater equity and efficiency in the basis for the taxation of savings.[14] The pragmatic reasons for such a DIT are the argued benefits in relation to the complexity of the current tax system, tax structure and tax rate biases, finance and compliance costs.[15] The theoretical arguments for the implementation of a DIT system are the benefits of achieving greater tax neutrality through treating income based on its economic substance, irrespective of the legal structure of the business.[16] Neutrality is certainly the one tax policy goal that is desired, and it needs to be balanced with the objectives of the tax policy such as: equity, fairness, efficiency, simplicity, revenue raising capacity, reduction in compliance costs and promoting domestic investments. Non-neutrality in the tax system can lead individuals and business practitioners to structure the substance of their activities in a manner that minimise tax liabilities.[17] Tax neutrality focuses on the notion that if a tax system has a potential to distort economic decisions then tax may adversely affect investment decisions and result in inefficient economic decisions. The concept of 'tax neutrality' refers to a system that does not influence personal and financial choices and does not create a bias for taxpayers in choosing one investment over another.[18]

To date there is very little Australian research regarding the introduction a DIT for small businesses, and what the implications of such a system could be for this sector. This study seeks to critically analyse whether such a DIT system will benefit Australian small businesses, by considering whether a DIT would achieve greater tax neutrality in relation to the choice of business structure.

In order to achieve this aim, it is important to firstly detail the concept of tax neutrality and its importance to the design of a tax system. This is then followed by a description of the Australian small business sector in Australia, and the business structures they use. Then a detailed review of the DIT system introduced overseas and the model proposed recently in Australia will be provided. Followed by a detailed analysis of the DIT system in terms of tax neutrality; recommendations and limitations are addressed before the article is concluded. It will be argued that while there is the potential for a DIT to improve tax neutrality for Australian small businesses, greater development of an Australian DIT model needs to occur, otherwise more choices could lead to greater distortion and less tax neutrality.

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[14] Ibid.
[15] Kokkinos and Sakell, above n 12.
[16] Peter Birch Sorensen, Dual Income Taxes: A Nordic Tax System. Tax Reform in Open Economies: International and Country Perspectives (Edward Elgar, 2010) 78.
[17] Jason Furman, 'The Concept of Neutrality in Tax Policy' (Paper presented at the testimony Before the U.S. Senate Committee on Finance Hearing on "Tax: Fundamentals in Advance of Reform", 15 April 2008).
[18] Douglas A Kahn, 'The Two Faces of Tax Neutrality: Do they Interact or are they Mutually Exclusive?' (1990) 18(1) *Northern Kentucky Law Review* 1.

II. TAX NEUTRALITY

The basic concept of tax neutrality is that decisions are based on their economic virtues and not on tax motives.[19] It is perceived that if a tax system has a potential to distort economic decisions then tax may adversely affect investment decisions and result in inefficient economic decisions. The concept of 'tax neutrality' refers to a system that does not influence personal and financial choices and does not create a bias for taxpayers in choosing one investment over another.[20]

The literature has emphasised the importance of an ideal neutral tax system and research into tax neutrality has a long history. Deterministic examples are the cash flow study conducted by Brown;[21] and Samuelson's study of the taxation of income and the present discounted valuation of assets, in which he emphasised the importance of all optimisation decisions, which can be independent of the tax rate each taxpayer is subject to.[22] Johansson discussed the issue of neutrality in corporate taxation.[23] Recently, researchers have shown an increased interest in tax neutrality in the light of tax policy uncertainty, such as the effects of different uncertain tax factors on investment behaviour.[24] Dixit *et al.* found that the uncertainty in tax policy can complicate and depress investment.[25] However, this view was rejected by Niemann, who argued that in some cases tax policy uncertainty might in fact encourage real investment.[26]

The idea of tax neutrality is that in perfectly competitive economics government should not skew private investment decisions. In general, the tax system should strive to be neutral, but in some circumstances, it is impossible to achieve this goal without certain levels of distortion influencing taxpayer decisions.[27] In theory, tax neutrality is a broadly accepted concept, and a foundation for any canonical aim of tax reform. However, in practice, trade-offs amongst tax neutrality and different goals may not be easily resolved.[28] For example, the notion of equity can be a stronger policy motivator than neutrality when it comes to a tax system being politically acceptable.[29]

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[19] Furman, above n 17.
[20] Kahn, above n 18.
[21] Eric C Brown, 'Business-income Taxation and Investment Incentives, in Domar et al., eds., *Income, Employment and Public Policy, Essays in Honor of A H Hansen,* (New York: Norton, 1948) 300.
[22] Paul A Samuelson, 'Tax Deductibility of Economic Depreciation to Insure Invariant Valuations' (1964) 72(6) *Journal of political economy* 604.
[23] Sven-Erik Johansson, 'Income Taxes and Investment Decisions' (1969) 71(2) *Swedish Journal of Economics* 104.
[24] Avinash K Dixit and Robert S Pindyck, *'Investment Under Uncertainty'* (Princeton University Press, 1994) 93; Rainer Niemann, 'Neutral Taxation Under Uncertainty: A Real Options Approach' [1999] *Public Finance Analysis* 51; Caren Sureth, 'Partially Irreversible Investment Decisions and Taxation under Uncertainty: A Real Option Approach' (2002) 3(2) *German Economic Review* 185.
[25] Dixit and Pindyck, above n 24*,* 93.
[26] Rainer Niemann, 'Tax Rate Uncertainty, Investment Decisions, and Tax Neutrality' (2004) 11(3) *International Tax and Public Finance* 265.
[27] Furman, above n 17.
[28] Ibid.
[29] Simon James, 'The Complexity of Tax Simplification: The UK Experience' in the Complexity of Tax Simplification – Experiences from Around the World (Edited by Simon James, Adrian Sawyer and Tamer Budak, 2016) *Palgrave Macmillan* 231.

From a neutrality perspective, similar activities should be treated in similar ways under a neutral tax system. For example, a neutral system taxes all consumption equally, minimising the distortion in peoples' choices. However, neutrality in the tax system is not always appropriate: for example, it can be argued that lack of neutrality is valuable in some cases such as the consumption of undesirable products.[30] In view of this argument a tax system departs from neutrality in order to discourage or encourage certain activities. To demonstrate, taxes have been used to influence decisions towards smoking and alcohol consumption and towards environmental harms.[31] Taxes (or tax concessions) have also been used to support certain activities, such as encouraging research and development activities and childcare. It has been argued that such non-neutralities should be introduced only after other approaches have been shown to be ineffective.[32]

Kahn pointed out that a tax system will influence taxpayer decisions regardless of the way the system is designed, even if the system is designed to be neutral to specific choices.[33] For example, consider a sole proprietor with his or her income from business taxed at a marginal tax rate of 49%: the government can be seen as a silent partner to this taxpayer, so that the government collects approximately half of the profit and bears approximately half of the business losses. This may have a great impact on the taxpayer's business choices when considering whether to incur a business expense or not. Therefore, the taxpayer's choice could be distorted, taking into account that only approximately 50% of the cost will be borne by the taxpayer, with the government bearing the other half of the cost. Critical concerns arise, that the operation of the tax system may create a tax bias toward personal and financial choices. Kahn also states that it is hard to eliminate tax influences, as they are an inadvertent cost of having an income tax system.[34]

Mirrlees and Adam maintained that the absence of neutrality and simplicity invites tax avoidance. Taxpayers intentionally arrange their activities in response to tax changes, in order to minimise their tax liabilities, even though the underlying economic activities are still the same.[35] The notion of tax neutrality can be seen to be embedded in Part IVA of the *Income Tax Assessment Act 1936* (Cth) which is the general anti-avoidance provision that applies when a taxpayer enters into a scheme for the sole or dominant purpose of obtaining a tax benefit.[36] Freudenberg has argued that essentially Part IVA can apply to taxpayers who have been motivated by breaches of tax neutrality to structure their tax affairs.[37]

Considering small businesses, Burton argued persuasively that "the current Australian taxation system clearly operates in a non-neutral fashion … for small business tax concessions upon the

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[30] James Mirrlees and Stuart Adam, *Tax by Design: The Mirrlees Review* (Oxford University Press, 2011).
[31] Furman, above n 17; Anna Mortimore, 'What Now for Environmental Sustainability: Government Fails to Link the Australian Car FBT Concession to Vehicle Emissions' (2011) 26 *Australia Tax Forum* 541.
[32] John T Ralph, *A Tax System Redesigned: More Certain, Equitable and Durable: Report / Review of Business Taxation*, Report of the Ralph Committee (1999) Vol 3, 105.
[33] Kahn, above n 18.
[34] Kahn, above n 18.
[35] Mirrlees and Adam, above n 30.
[36] *Income Tax Assessment Act 1936* (Cth) pt IVA s 177(d).
[37] Freudenberg, above n 8, Ch 2.

basis that they serve to 'level up' the uneven tax field".[38] For example, the justification for the introduction of small business capital gains rollover tax concessions has been built upon the rational that a small business owner does not have the concessional treatment of superannuation savings that is available to an employee.[39] However, Burton argued that if the justification for small business capital gain tax (CGT) concessions is based on employee concessional superannuation, then there should be a need for restriction rules to apply to the eligibility of those concessions in parallel with the restrictions placed upon employee superannuation.[40] The justification for CGT concessions is to address the issue of equity: that is small businesses reinvest income back into the business because small business owners may not provide for their retirement. Therefore, by addressing the issue of equity it may mean the tax system for small business cannot be neutral.

The importance of tax neutrality has been acknowledged by governments and discussed in many tax reviews, such as the Asprey Report in Australia.[41] A key aspect of this principle is that it requires a tax system which should be neutral between business and consumption choices and which should not influence taxpayer choices.[42] Its importance was further emphasised by the Ralph Committee:

> Ideally the business tax system should be neutral in its impacts and thus not be a consideration in business decision-making. Poorly designed tax system can inhibit economic growth by distorting business decisions.[43]

Any departure from the principle of neutrality in the tax system may result in adverse effects; this was highlighted more recently in the Henry Review. Indeed, the Henry Tax Review noted the current breaches of tax neutrality with the range of business structures, as there are significant differences in the applicable of tax rates amongst them.[44] Such differences may result in inefficient outcomes that can impact on business productivity.[45] This point is of great importance, as tax distortions can arise when incomes derived from various business structures are taxed differently.

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[38] Mark Burton, 'Australian Small Business Tax Concessions-Public Choice, Public Interest or Public Folly' (2006) 21 *Australian Tax Forum* 71, 82.
[39] Ibid.
[40] Ibid.
[41] Australia Commonwealth Taxation Review Committee-Kenneth W Asprey, *Full Report,* Government Publishing Service (1975) 16.
[42] Ibid.
[43] Ralph, above n 32, 105.
[44] Henry, above n 13.
[45] Ibid.

III. SMALL BUSINESS STRUCTURES AND TAX NEUTRALITY

Small businesses range across all sectors of the economy and are mostly concentrated in construction, agriculture and professional services.[46] In considering the business structures used by small businesses, it is important to gain understanding about the utilisation of different business structures. Income returns data for 2014–15 demonstrated that 3,232,117 taxpayers indicated that they were conducting a business: sole traders accounted for the largest percentage (36%); partnerships had the lowest percentage (10.2%), with trusts 25.5% and companies 28.3%:[47] Table 1.

Table 1: Lodgement of Tax Returns–Business

Business Structure	2014-15
Sole Traders	1,163,541
Partnerships	330,620
Trusts	823,448
Companies	914,508
Total	3,232,117

Source: Australian Taxation Office, *Taxation Statistics: A summary of tax returns for the 2014-15 income year*, https://www.ato.gov.au.

In terms of size, for taxpayers with annual business income less than $2 million (known as 'micro' businesses) the sole proprietor structure is the most popular (48 per cent), followed by corporations (29 per cent), with trusts and partnerships at approximately 13 and 11 per cent respectively. When considering the business structures for those businesses with annual income from $2 million to $10 million, then it is evident the corporation is the most popular structure, accounting for 64 per cent of businesses, followed by trusts at 25 per cent, then partnerships at 8 per cent and sole proprietors at 3 per cent: Table 2. Although it should be noted that small business may choose a combination of business structures to be adopted by one business firm in order to achieve desirable taxable and non-taxable attributes.[48]

[46] Australian Bureau of Statistics, above n 2.
[47] Australian Taxation Office, *Taxation statistics 2014–15* (ATO, 2017).
[48] Brett Freudenberg, 'Tax on my Mind: Advisors' Recommendations for Choice of Business Form' (2013) 42(1) *Australian Tax Review* 33.

Table 2: AUS: Lodgement of Tax Returns-Business - Size

Business structure	Loss < $0	Nil = 0	Micro >0 but <$2M	Small > $2M but < $10M	Medium > $10 but < $100M	Large >$100M but < $250 M	Very large > $250 M
Sole proprietor	1022	12,050,273	1,159,231	2,996	289	2	1
Partnerships	160	65,737	255,963	7,638	1,018	61	43
Trusts	600	481,883	312,392	24,145	4,212	166	50
Corporations	1,567	125,936	706,860	61,173	16,497	1,345	1,130
Total	3,349	12,723,829	2,434,446	95,952	22,016	1,574	1,224

Source: Australian Taxation Office, *Taxation Statistics: A summary of tax returns for the 2014-15 income year*, https://www.ato.gov.au.

In Australia the legal structure implemented by a business can have significant effects on the business tax liabilities and the tax concession eligibility. Taking all of this into consideration, the Australian tax system does not achieve tax neutrality. Briefly for income tax purposes, income derived from business activities conducted by a sole proprietor is included in the individual's assessable income and is taxed pursuant to the appropriate marginal tax rates, plus Medicare levy. Currently, Australia has progressive marginal tax rates, with the maximum rate for individuals at 47 per cent for taxable income over $180,000 for the income year 2016-17. A general partnership is subject to tax flow-through, with partners paying tax in accordance with their individual shares of the net partnership income or loss.[49] Limited partnerships[50] are taxed as corporations in Australia.[51] For corporations and their members (shareholders), Australia has adopted an imputation system.[52] Pursuant to an imputation system the corporation is still taxed separately on its income, though resident members in receipt of franked dividends from Australian resident corporations can obtain credit for a proportional amount of income tax paid by the corporation.[53] Franked dividends are those paid from profits that have borne corporation tax. Currently, the corporate tax rate in Australia is 30 per cent, with a lower rate of 27.5 per cent for small business corporations.[54] Trusts are subject to a partial tax flow-

[49] *Income Tax Assessment Act 1936* (Cth), s 92.

[50] A limited partnership is defined for tax purposes as either: (a) an association of persons (other than a company) carrying on business as partners or in receipt of ordinary income or statutory income jointly, where the liability of at least one of these persons is limited; or (b) an association of persons with a separate legal personality that was formed solely for the purpose of becoming a VCLP, an AFOF or a VCMP and to carry on activities that are carried on by a body of that kind: *ITAA 1997* (Cth), s 995-1.

[51] The flow-through treatment of limited partnerships was eliminated by the introduction of *ITAA 1936* (Cth), Division 5A with limited partnerships being defined as 'corporate limited partnerships'.

[52] This includes corporate limited partnership [except for the tightly regulated venture capital incorporated limited partnerships: *ITAA 1936* (Cth), s 94D (2)] and public unit trusts.

[53] *Income Tax Assessment Act 1997* (Cth), s 207-20.

[54] Individual members in receipt of franked dividends include in their assessable income the amount of the cash dividend received and the imputed amount of the corporation's profits (often referred to as the 'gross-up' amount of the dividend). A credit is then given to the taxpayer (a 'franking credit' or 'franking rebate'), equal to the

through system: income can be assessed directly to members (beneficiaries) but losses are confined within the trusts themselves. Beneficiaries who are presently entitled to the income of the trust are taxed on their respective share of the trust's net income.[55]

The critical question here concerns the tax policy objectives in respect to business structures, under the assumptions that a taxation system should neither distort commercial decisions in relation to the adoption of business structures nor allow similar economic activities to be taxed differently. This view was highlighted in the Asprey review.[56] In principle, the taxation system should demonstrate neutrality between different legal structures, unless the reasons for divergence can be justified.[57]

It is crucial to draw attention to a fiscal point: there is a tendency towards a decrease in capital income and incorporation tax rates in favour of achieving greater competitiveness and efficiency.[58] That is, by lowering capital and corporate income tax rates, governments may try to attract corporate activities and investment, as well as profit-shifting, into their jurisdiction.[59] In order to compensate for government revenue losses, some argue that lower corporate tax rates could result in an increased tax burden on labour income earners.[60] The differential in tax treatment between individual and business structures raises issues of concerns.

For example, currently in Australia, the corporate income tax rate is significantly below the individual highest marginal tax rate on labour income.[61] For this reason, Freedman argued that the difference in rates could distort the choice for business structures for small businesses and could deter the use of small business resources for tax planning rather than for productive activities.[62] Similarly, in Australia the distortion relating to the difference in tax rates between different business structures may adversely impact on business productivity, as emphasised

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imputed amount that is then decreased from the individual's primary tax liability. If there are excess franking credits, then from 1 July 2000 certain members are eligible to a refund of this excess amount.

[55] *Income Tax Assessment Act 1936* (Cth), s 97. In the circumstance where the beneficiary, although presently entitled, is under a legal disability, the trustee is taxable on the share of trust net income in a representative capacity. The trustee is also assessable in cases where the beneficiary is a non-resident. All net income of the trust to which no beneficiary is presently entitled initially falls within the ambit of s 99A, with the trustee liable for tax. In a limited number of cases, the Commissioner has discretion to assess the trustee under s 99.

[56] Australia Commonwealth Taxation Review Committee-Kenneth W Asprey, above n 41*,* 16.

[57] Judith Freedman, 'Reforming the Business Tax System: Does Size Matter?' in C. Evans and R. Krever (eds) *Australian Business Tax Reform in Retrospect and Prospect*, 153 (Thomson Reuters, 2009).

[58] Rachel Griffith, James Hines and Peter Sorensen, *'International Capital Taxation' in Dimensions of Tax Design: The Mirrlees Review* (Oxford University Press, 2010), 914.

[59] An example from 2016-17 Federal Budget with the proposal to decrease corporate taxes for businesses with an aggregated turnover of less than $10 million to be lowered to 27.5 per cent. Australian Government. Budget 2016-17. http://budget.gov.au/2016-17/content/glossies/overview/html/overview-02.htm.

[60] Judith Freedman and Claire Crawford, "Small Business Taxation", in S Adam, T Besley, R Blundell, S Bond, R Chote, M Gammie, P Johnson, G Myles and J Poterba, ed., *Dimensions of Tax Design: The Mirrlees Review* (Oxford University Press, 2010), Oxford Legal Studies Research Paper no 25, (2011).

[61] ITRA, Sections 23, 24 and 25. Corporate tax rate is 30%, reduced to 28.5% from 1 July 2015, whereas individual tax rate in the high bracket is 49% (including Medicare levy & budget repair levy of 2%); Australian Government. Budget 2016-17. budget.gov.au/2016-17/content/glossies/overview/html/overview-02.htm, corporate tax rate for small businesses (up to 10 million turn over) to be reduced to 27%.

[62] Freedman, above n 57.

in the Henry Review.[63] In recent years, the Australian Government has introduced a rebate of five percent of the income tax payable (capped at $1000) as a tax offset to address in some way the non-alignment between the small business company tax rate and the rates of those businesses conducted as a sole trader or partnership.[64]

The difficulty of achieving tax neutrality is even further evidenced if one considers the tax planning strategies available in a singular business structure. For example, individuals who choose to incorporate may access the lower corporate tax rate compared to the high marginal tax rate on labour income. Also, owners can shift their salary to dividends resulting in a reduction of their tax liabilities, especially employment related taxes. In addition, ownership of shares of corporation can be split between family members in order to benefit from a lower tax rate.[65] Shareholders can also benefit from the imputation system, in which a corporate entity is allowed to pass on credits for income tax paid, in the form of 'franking credits', to their members, and those members can claim tax offsets for those credits.[66] Additionally, a tax distortion occurs with corporations by sheltering income within the business structure by virtue of retained profits. Members then may switch the retained profit into capital gains through the disposal of their membership interest. Such capital receipts may benefit from deferral as well as from the capital tax rates concessions compared to income receipts.[67]

The choice of business structure with different tax implications may influence complexity, and thereby increase compliance costs. It has been argued that the cost of complying with tax obligations for small businesses can be high and regressive, as the burden disproportionately falls on smaller businesses.[68] Evans *et al*. (1997) found that compliance costs can be influenced by the choice of business structure.[69] While the 2014 study did not analyse the relationship between business structure and compliance costs,[70] it did find that increased complexity does drive up compliance cost.[71] Pitcher Partners argued that where business structures involve multiple legal structures, compliance costs and complexity become more intensified.[72]

It needs to be acknowledged that tax is not the only consideration, as the legal indicia of a business structure would also be influential in the adoption of the business structure. For

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[63] Henry, above n 13.
[64] *Tax Laws Amendment (Small Business Measures No. 3) Act 2015* (Cth). Australian Taxation Office (2016). Small Business - tax discount for unincorporated business. Unincorporated business that has an aggregated annual turnover of less than $2 million will be eligible to this tax offset.
[65] Freedman, above n 57.
[66] *Income Tax Assessment Act* 1997 (Cth), div 202 s 202-5.
[67] *Income Tax Assessment Act* 1997 (Cth), div 115 (capital discount 50%).
[68] Board of Taxation, Scoping Study of Small Business Tax Compliance Costs: A Report to the Treasurer, Attorney-General's Department Canberra (2007) 7; Cedric Sandford, Michael Godwin and Peter Hardwick *Administrative and Compliance Costs of Taxation* (Fiscal Publications, 1989); Chris Evans et al, 'Small Business and Tax Compliance Costs: A Cross-Country Study of Managerial Benefits and Tax Concessions' (2014) 12(2) *eJournal of Tax Research* 453.
[69] Chris Evans et all, 'A Report into Taxpayer Costs of Compliance' [1997] *Australian Government Publication Service.*
[70] Lignier, Evans and Tran-Nam, above n 1.
[71] Ibid.
[72] Kokkinos and Sakell, above n 12.

example, a company can provide limited liability and a separate entity status.[73] Furthermore, Maine states that reasons for choosing the entity approach is that the structure's choice is based on the legal theories of corporate personality rather than for tax purposes.[74]

One way to achieve greater tax neutrality between business structures is that members should be taxed directly on their business income, regardless of the business structure adopted.[75] Such a tax transparency can occur with a tax transparent company that can be defined as a separate legal entity, and a limited liability with flow-through taxation. The income from the transparent company is taxed at the hands of the members.[76] The S Corporations and the Limited Liability Companies in the United States of America (USA) and the Limited Liability Partnerships in the United Kingdom (UK) are some examples of tax transparent companies. Bevin also supported this view, stating that tax transparency is believed to enhance the neutrality and equity of the tax system.[77] This preference for transparency was embraced also by the Organisation for Economic Co-operation and Development (OECD) in its 1991 report. The OECD stated that for a greater achievement of equity and neutrality, a tax system should impose taxes not on organisations but rather on the income of individuals holding interests in the organisations.[78] Therefore, transparency may remove the incentives for members to shelter business income via the utilisation of the business structure, in order to avoid individual marginal tax rate obligation.[79] In some respects, a DIT system has some similarities to the tax transparent approach;[80] in this way a DIT system may reduce the relative distortions associated with structural biases.

A related question asks whether there is any evidence to support the argument that the taxpayers' motivation in choosing their business structure is due to tax treatment. That is: do breaches in tax neutrality between different business structures influence the taxpayer's choice of business structure?

Numerous studies have demonstrated that there is a potential influence by tax arbitrages for taxpayers when considering the choice of a business structure. In the USA, research by Scholes and Wolfson and by Gordon and Mackie-Mason has considered the effect on business structure choice due to 1986 Tax Reforms.[81] In the UK, Hicks *et al*. who investigated the reasons behind

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[73] *Corporation Act* 2001, s 124; *Salomon v Salomon & Co Ltd* {1897} AC 22.

[74] Jeffrey A Maine, 'Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises' (2000) 62 *University of Pittsburgh Law Review* 242.

[75] Matt Benge and Tim Robinson, *How to Integrate Company and Shareholder Taxation: Why Full Imputation is the Best Answer* (Victoria University Press for the Institute of Policy Studies, 1986).

[76] Brett Freudenberg, 'A Model Idea: Is the ICAA Proposal for a Tax Transparent Company the Ideal Model for Australia' (2009) 38(3) *Australian Tax Review* 161.

[77] Paul Bevin, *How Should Business Be Taxed? An Examination of Defects in Business Taxation and Suggestions for Reform* (Victoria University Press, Wellington, 1985) 96.

[78] Organisation for Economic Co-operation and Development, *Taxing Profits in a Global and Economy: Domestic and International Issues* (OECD Publishing, 1991).

[79] Sijbren Cnossen, 'Alternative Forms of Corporation Tax' (1984) 1(3) *Australian Tax Forum* 261.

[80] Freudenberg, above n 76.

[81] Myron S. Scholes and Mark Wolfson, 'Taxes and Organizations Theory' Paper for the Yale Conference on Economics of Organizations (1986) in D A Guenther, *The effect of income taxes on the form of business entity* (1990); Roger H Gordon and Jeffrey K Mackie-Mason, 'Effects of the Tax Reform Act of 1986 on

the small business choice to incorporate found that tax consideration was the second most important factor, from the advisors' point of view, whereas limited liability was the dominant reason to incorporate.[82] Also in the UK, Freedman and Goodwin found that, while tax was not the dominant reason for the choice of business structure, in fact tax did play a role, as close to 40% of participant choice was based on tax.[83]

Two Australian studies particularly explore the tax influence on business structure choice. Holub, who analysed the use of public trusts in relation to their tax treatment, found that the initial choice to utilise the public unit trust before the tax amendments could be based on tax considerations.[84] In a more recent Australian study, Freudenberg explored the important considerations regarding the formation of businesses. His findings suggest that asset protection and tax benefit are the two most important factors advisors consider when they recommend a business structure.[85] Together, these studies indicate that there is some evidence to support the argument that tax arbitrages can influence taxpayer choice of business structure; factors such as liability can also be a critical influence. It can be argued, based on the analysis provided, that the taxpayer's investment decisions may be distorted by breaches of the tax neutrality in terms of business structures, as investment decision is based on what is important to taxpayer. Thus, reducing risk maybe more important than achieving tax neutrality.

IV. DUAL INCOME TAX SYSTEM

Below is a discussion of the origin of the DIT system, how it operates broadly in the Nordic countries (the Nordic DIT), and the DIT model proposed by Pitcher Partners (the Pitcher Partners' DIT Model).

A *Origin*

The notion of the DIT system is commonly traced to the work of the Danish economist Professor Niels Christian Nielsen in 1980. Nielsen proposed the replacement of the comprehensive tax system by a system combining a flat rate of tax on capital income, at the level of the corporate income tax rate, with progressive tax rates on labour income. Denmark

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Corporate Financial Policy and Organizational Form*'* (Working Paper No 3222, National Bureau of Economic Research, January 1990).

[82] Andrew Hicks, Robert Drury and Jeff Smallcombe, 'Alternative Company Structures for the Small Business' in *ACCA Research Report No 42*, (Certified Accountants' Educational Trust, 1995).

[83] Judith Freedman and Michael Godwin, 'Incorporating the Micro Business: Perceptions and Misconceptions' in A Hughes and D Storey (eds), *Finance and the Small Firm, Routledge, London* (1994) 232.

[84] Mark J Holub, *Taxes and the Choice of Organisational Form in Australia* (University of Western Australia, 2001) 3.

[85] Freudenberg, above n 48.

was the first to implement the DIT system, in 1987.[86] In the early 1990s, the DIT system spread to other Nordic countries: Sweden in 1991; Norway in 1992[87] and Finland in 1993.[88]

Several other countries outside the Nordic region have now implemented, or have introduced elements of a DIT. In 1996, Italy introduced a DIT, primarily for corporate earnings, that provided large tax cuts for companies reinvesting profits or issuing new equity on the stock market for the first time.[89] The main purpose of this tax reform was to encourage Italian companies to increase their capital assets, in order to shift from reliance on traditional debt towards reliance on equity risk capital.[90]

Tax proposals favouring the implementation of DIT have been made for Switzerland and Germany.[91] In Germany, the major aim of the tax reform is to simplify the current tax system and to offer a tax rate reduction, particularly for international mobile capital income.[92]

B *The Nordic DIT*

In 1993, Sorensen described the new Nordic tax system as "a deliberate move away from the principle of Global Income Taxation towards a system of so-called 'Dual' Income Taxation".[93] In 2007 he referred to the system as "a compromise between the progressive comprehensive income tax and the expenditure tax".[94] Under a progressive global tax a single progressive tax rate is applied to the total taxpayer incomes from all sources.

By contrast, under the DIT system, capital income is taxed separately from other sources of income.[95] The DIT system (also known as the Nordic tax system) is a particular form of scheduler income tax that applies a separate low proportional tax rate to capital income and progressive tax rates to labour income.[96] 'Capital income' is defined as the imputed return on the business assets, and 'labour income' is classified as the difference between total business income and the imputed capital return.[97] Business assets could be defined as the recorded book value of the firm's depreciable assets plus acquired goodwill and other acquired intangible assets.[98] Capital income is taxed at a single flat rate that is equivalent to the lowest marginal

[86] Peter B Sorensen, 'From the Global Income Tax to the Dual Income Tax: Recent Tax Reforms in the Nordic Countries' (1994) 1(1) *International Tax and Public Finance* 57.
[87] Jonas Agell, Peter Englund and Jan Sodersten, *Incentives and Redistribution in the Welfare State: The Swedish Tax Reform* (St. Martin's Press, 1st ed, 1998) 186.
[88] Bernd Genser and Andreas Reutter, 'Moving Towards Dual Income Taxation in Europe' (2007) 63(3) *Public Finance Analysis* 436.
[89] G Forlani, 'Italy: Dual Corporate Income Tax System' (1997) *World Tax Report* 185.
[90] Ibid.
[91] Genser and Reutter, above n 88.
[92] Wolfgang Wiegard, 'For a Dual Income Tax' (2005) 6(3) *CESifo Forum* 56.
[93] Sorensen, above n 86, 1.
[94] Peter B Sorensen, 'The Nordic Dual Income Tax: Principles, Practices, and Relevance for Canada' (2007) 55(3) *Canadian Tax Journal* 557, 562.
[95] Sorensen, above n 86.
[96] Sorensen, above n 94.
[97] Bernd Genser, 'The Dual Income Tax: Implementation and Experience in European Countries' (2006) 57(3-4) *Ekonomski pregled* 271.
[98] Griffith, Hines and Sorensen, above n 58, 914.

tax rate on non-capital income. In the pure version of the system, the capital income tax rate is aligned with both the corporate tax rate and the lowest marginal tax rate on labour income.[99] Under the DIT system, the capital income tax base should be as broad as possible in order to achieve homogeneity and neutrality in capital income taxation. Therefore, capital income from all sources would include capital gains, interest, dividends, royalties, rental income, imputed returns on owner-occupied housing and imputed returns on capital invested in non-corporate firms.[100] The component for non-capital income includes labour income from employment and self-employment, wages and salaries, non-monetary fringe benefits, private and public pensions, and government transfers.[101]

In summary, a DIT system in its purest form has the following characteristics:

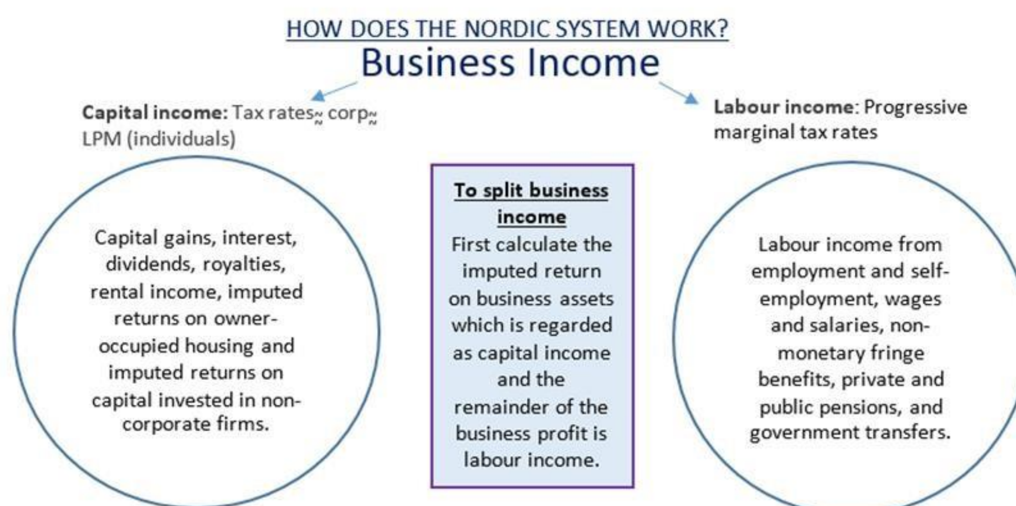
- A flat uniform personal tax rate that applies to all forms of capital income, equalling the corporate income tax rate;
- The lowest marginal tax rate on labour income, aligned with both the capital and the corporate tax rates;
- No double taxation on corporate equity income (no double taxation on dividends: shareholders receiving dividends are given full credit for taxes paid at the corporate level); and
- A broad tax base for capital income (as outlined above).[102]

The DIT can apply to small business owners who are self-employed, to sole proprietorships and to partnerships;[103] as well as to closely held companies if the active owner (works in the business) and owns more than two thirds of the firm.[104] In general, the owners of small businesses work in their own business; therefore, part of their income is regarded as labour income. Similarly, the owners have also invested some or all of their saving in their business; therefore, the other part of their income is regarded as a return on their business assets and is treated as a capital income.[105] When the income return derives as a single aggregated amount, some concerns have been raised, as business income is not split into capital and labour incomes. If the aggregated business income were to be treated as labour income at progressive rates, this would result in overtaxing owners' capital income, compared to other types of capital income, especially as many owners of small businesses are active in their business. On the other hand, if all business income were to be treated as capital income, this would result in the business owners avoiding the progressivity of tax rates on labour income.[106] To avoid such a discrepancy

[99] Peter B Sorensen, 'Dual Income Taxation: Why and How?' (2005) 61(4) *Public Finance Analysis* 559.
[100] Peter B Sorensen, 'Dual Income Taxes: a Nordic Tax System' in I Claus, N Gemmell, M Harding and D White (eds) *Tax Reform in Open Economies: International and Country Perspectives* (Edward Elgar, 2010) 78.
[101] Robin Boadway, 'Income Tax Reform for a Globalized World: The Case for a Dual Income Tax' (2005) 16(6) *Journal of Asian Economics* 910.
[102] Sorensen, above n 99.
[103] Ibid.
[104] Genser and Reutter, above n 88.
[105] Sorensen, above n 99.
[106] Ibid.

in tax treatment, it is necessary to divide business income into two categories: capital income and labour income. In practice, the number of working hours contributed to firms by business owners is seen as subjective, as determined by the owner, and can be difficult to prove to tax authorities. In comparison, business assets are seen as more objective. From this perspective, in splitting business income, the rule is to first calculate the imputed return on business assets, regarded as capital income, and then to treat the remainder of the business profit as labour income. The imputed rate of return can be set in accordance with the applicable interest rate on average government bonds plus the risk premium.[107] Figure 1 outlines how business income can be divided into the two components required for a DIT system.

Figure 1: Nordic DIT System



Source: Sorensen, P. B. (2005). Dual income taxation: why and how? FinanzArchiv/Public Finance Analysis

The two major splitting methods to calculate the imputed return on business assets, gross-assets and net-assets are illustrated in Table 3. In Sweden and Finland, the splitting method is based on net-assets, whereas in Norway a gross-asset method is used.[108] Under the gross-assets method, the firm's net financial liabilities are not deducted from the asset base. To calculate the labour income of the business owner, the imputed return on gross business assets is calculated first (capital income); this then is deducted from the gross profits (profit before interest) of the firm and is classified as labour income. The taxable net capital income is calculated as the imputed return to the gross assets less the interest expenses.[109] In contrast, under the net-assets method, capital income is calculated by computing the imputed return on

[107] Ibid.
[108] Tobias Lindhe, Jan Sodersten and Ann Oberg, 'Economic Effects of Taxing Different Organizational Forms under the Nordic Dual Income Tax' (2004) 11(4) *International Tax and Public Finance* 469.
[109] Sorensen, above n 99.

net assets of the firm (business assets less business liabilities), then this imputed return is deducted from the firm's net profit (profit after interest) to determine the labour income of the firm's owner.[110]

Table 3: Nordic Splitting Methods for Imputed Return

Gross-assets method	The imputed return is calculated on the gross assets of the business (firm's financial liabilities are not deducted from the asset base).
Net-assets method	The imputed return is calculated on the net assets of the business (firm's financial liabilities are deducted from the asset base).

Source: Sorensen, P. B. (2005). Dual income taxation: why and how? *FinanzArchiv/Public Finance Analysis.*

With this understanding of the Nordic DIT, it is important to consider the Pitcher Partners DIT Model.

V. PITCHER PARTNERS' DIT MODEL

Pitcher Partners, an Australian accounting firm, in 2015 put forward to the members of the Tax Force a submission for a DIT system,[111] as an option for a systemic tax reform. In this recommendation, they suggested a DIT model with the primary objective being the alignment of income tax rates; that is, the tax rate on capital income to be aligned with the corporate tax rate and also with an appropriate marginal tax rate.[112] The Pitcher Partners' DIT Model combines progressive tax rates on labour income and a lower flat rate on all capital income. The purpose of broadening the capital income tax base is to eliminate arbitrage, to reduce the incentives relating to negative gearing and to achieve tax neutrality with saving and investment income. Unfortunately, in the Pitcher Partners' DIT Model there is no detailed description of the items that would be included in this broad tax base.

Pitcher Partners proposed a DIT model which required a reduction in some tax rates, including the top personal tax rate, to be aligned with the corporate tax rate and to be lowered to 30% (it appears up to a taxable income of $312,500 threshold and then 45% for taxable income above $312,500). Such a change in the individual tax rates was estimated to cost the government between $13 billion and $22 billion in lost tax revenue in 2012-13 income year.[113] If both the corporate and the marginal tax rates were to be reduced to 27%, for private

[110] Ibid.

[111] Kokkinos and Sakell, above n 12.

[112] Peter B Sorensen, *Dual Income Taxes: A Nordic Tax System,* (Department of Economics, University of Copenhagen, 2009), 2.

[113] Australian Taxation Statistics. (2012–13). Individuals: Percentile distribution of taxable individuals, by taxable income and gender, 2012–13 income year. Cited in Kokkinos and Sakell, above n 12.

companies only, this may result in further lost tax revenue.[114] Pitcher Partners argued that the potential loss in tax revenue may be compensated by an increase of the Goods and Services Tax (GST) rate to 15%.[115] Pitcher Partners suggested that this could increase government revenue by approximately $27 billion, assuming that the GST base is kept constant.[116] This can be seen as an increased level on tax on consumption while the tax on capital is lowered.

Further recommendations were made for a simpler system in regards to reforming the small business capital gains tax (CGT) concessions, which would include removing the current threshold eligibility requirements and allowing all capital gains derived from an active asset to be tax free to all individuals, up to a set cap ($1 million).[149] Pitcher Partners argued that by implementing these changes the complexity of small business taxation might be simpler and this would help in reducing compliance costs. Unfortunately, no evidence was provided to support their claim in this regard.[117]

Pitcher Partners also recommended moving to a 40% discount on capital gains and savings income, including interest and rent.[118] Basically, the discount percentage represents the difference between the top marginal rate and the corporate tax rate.[119] These rates could potentially achieve equity between different structures and different types of income.

Overall, the DIT model proposed by Pitcher Partners had little details about the DIT itself but contained a lengthy discussion of its potential implication with current integrity rules.[120] These integrity rules include the personal service income rules to ensure that labour income is not shifted to business profits.[121] Since labour income and corporate profit are taxed at the same rate, this tax provision would ensure that only appropriate deductions are being claimed. Furthermore, there would appear to be little need for rules to ensure that income from labour is not transferred to capital income, since both rates are the same in the Pitcher Partners' DIT Model up to $312,500 threshold, and there would be no tax benefit in doing so up to this amount.[122]

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[114] In other countries (implementing the DIT) the top marginal tax rate on labour income is higher than the corporate tax rate.
[115] Kokkinos and Sakell, above n 12.
[116] Australian Taxation Statistics, above n 113. Cited in Kokkinos and Sakell, above n 12.
[117] Kokkinos and Sakell, above n 12.
[118] Australia, Australia's Future Tax System Consultation Paper (2008). *HTTP:< http://taxreview. treasury. gov. au/content/Consultation Paper. aspx*. 6.5. The 40% discount rate is in line with Henry's recommendation.
[119] An example to demonstrate this, assuming that the top marginal tax rate is 50% and the discount rate on capital income is 40%. Taxpayer X made a $1000 income from capital, if 40% discount were to apply to this amount and taxpayer X was to be taxed at 50% this would result in $300 tax liabilities, as this would be equal to the corporate tax rate.
[120] The Pitcher Partners Model can be described as a DIT but not as a pure version DIT because the top marginal tax rate on labour income is aligned with both the corporate and capital tax rates, whereas, in the pure version of the system the lower marginal tax rate on labour income is aligned with both the corporate and the capital tax rates.
[121] *Income Tax Assessment Act 1997* (Cth), div 86 (Alienation of personal services income). Thus, Division 86- Alienation of personal services income can provide a protection.
[122] Kokkinos and Sakell, above n 12. Pitcher Partners dealt with the issues between capital and labour income by just making the tax rates all the same.

With this understanding of the DIT systems and the current tax treatment of business structures in Australia, the next section critically analyses whether a DIT could improve tax neutrality in Australia.

VI. NEUTRALITY AND DIT

This section critically assesses claims of improved tax neutrality for a DIT system, reflecting on the Nordic model, as well as the Pitcher Partners' DIT Model.

A *Tax Neutrality and the Nordic DIT*

The original case for a dual income tax system was to address tax non-neutralities. One of the main features of the DIT is having a separate flat tax for capital income. The theoretical arguments for such tax are the adjustment for inflation and that the present value of returns on investment is not affected by a tax that uniformly applies to all types of capital income, thus ensuring neutrality in investment. The rationale that founded this theory is the equality between tax and the economic depreciation and the deduction of debt interest.[123] Prior to the transition to the DIT, in Norway and Sweden many taxpayers in high-income brackets took advantage of interest deductibility expenses to reduce their tax liability which caused a large revenue loss in the personal capital income tax in the late 1980s. After the transition to the DIT and the capital income tax rates were lowered, the revenue loss from interest deductibility was significantly reduced. This led to a revenue gain which enabled the governments to lower the tax burden on labour income.[124]

Generally, the key principle of a DIT is aligning the capital tax rate with the corporate tax rate. This is seen as important to eliminate the incentives for choosing between corporate and non-corporate business structures.[125] To address this, for example, a revision of the 1992 Norwegian tax reform was made in 2006, to provide an equal tax treatment for business owners who have chosen different business structures in carrying out their business activities. This saw the introduction of the shareholder income tax in 2006, which aimed to reduce the incentives for business owners when choosing business structures for tax purpose.[126] These reforms are said to have improved horizontal equity.[127]

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[123] Hans-Werner Sinn, 'Capital Income Taxation and Resource Allocation' (1987) 35 S*pringer* 204.
[124] Sorensen, above n 100, 78.
[125] Boadway, above n 101.
[126] Shareholder income tax applies to all resident shareholders of listed and unlisted sharers. Dividends and realised capital gains in excess of an imputed return to the stepped-up basis of the shares are subject to be taxed at a flat capital income tax rate in addition to the corporate tax on the profits. So, the total of the corporation tax and the capital income tax on the excess returns on shares will be approximately equal to the top marginal tax rate on labour income (this was necessary to correct the inequity that had existed under the 1992 tax reform).
[127] Erlend Bo, Peter Lambert and Thor Thoresen, 'Horizontal Inequity under a Dual Income Tax System: Principles and Measurement' (2012) 19(5) *International Tax and Public Finance* 625.

Theoretically, tax rates should be the same, irrespective of the business structure adopted, as this is crucial in achieving the principle of tax neutrality. Under the DIT system, income is taxed on the basis of its economic substance, regardless of the legal structure or label.[128] In theory, this may eliminate tax rate biases that exist due to different business structures.[129] However, this view was contradicted by De Mooij and Nicodeme, who observed that lower corporate tax rates have resulted in income shifting from personal to corporate income in several European countries.[130] This has been mainly demonstrated in the form of lower personal income tax revenue, because many small companies have incorporated to benefit from the tax disparity.[131] These authors further explained that this income shifting occurs particularly when entrepreneurs need to choose the legal structure for their business activities, with differences between personal and corporate income taxes influencing this choice.[132]

In the context of business taxation, there is a merit in taxing all business structures the same, though it is unclear how to apply the DIT system to trusts. It should be noted that the use of trusts as a business structure is largely absent in the Nordic jurisdictions.

B *Income vs Capital*

The progressive tax rate does not apply to capital income; all capital income is taxed at a flat capital rate under the DIT system. Indeed, the system demonstrates a tax neutrality concerning saving, investment and risk-taking by individuals.[133] Sorensen points out that when the capital income tax rate is low, this may assist in reducing tax non-neutralities through broadening the capital income tax base. According to Sorensen, the Nordic experience suggests that, prior to the implementation of DIT in Norway; a large proportion of private savings was channelled into investing in tax-exempt capital gains or low-taxed assets such as owner-occupied housing and retirement savings.[134] These techniques saw a decline in tax revenue. By lowering the capital income tax rate and broadening its base through the transition to a DIT system, thus generated a revenue gain.[135] This was seen as improving horizontal and vertical equity amongst taxpayers.[136] Pirttila and Selin argued that a lower tax rate on capital income may reduce the

[128] Richard Bird and Eric Zolt, 'Dual Income Taxation and Developing Countries' (2010) 1(2) *Columbia Journal Tax Law* 174.
[129] Kokkinos and Sakell, above n 12.
[130] Ruud de Mooij and Gaetan Nicodeme, 'How Corporate Tax Competition Reduces Personal Tax Revenue (2008) *CESifo DICE Report* 27.
[131] Ibid.
[132] Ibid.
[133] Boadway, above n 101.
[134] Sorensen, above n 100, 78.
[135] Ibid.
[136] Ibid.

incentives for tax avoidance through profit shifting and other schemes and may reduce the benefit of tax arbitrage obtained from leveraging.[137]

Capital income can be derived in many forms, some of which are difficult to tax due to political and financial reasons, such as taxing unrealised capital gains and accrued income from returns on institutional savings. Generally, governments can be reluctant to tax such income due to difficulties in measuring it and/or to the lack of liquidity required by the taxpayer to pay tax liability on unrealised income.[138] Applying a lower tax rate to different types of capital income may decrease the degree of distortions that arise as a result of excluding certain types of capital income from the tax base.[139] A low flat tax rate on capital income may also encourage the inclusion of realised capital gains in the tax base without the distortion associated with the disposal of assets.[140] An example of this potential distortion is when the disposal of an asset is deferred until the time of realisation, implying a tax preference for capital gains in a lower income period, and resulting in a tax deferral benefit.[141] In the Australian context, a research by Minas has demonstrated that the assertion that the introduction of the 50% discount for capital gains would stimulate capital realisations and result in greater tax revenue was not supported by the data.[142] Instead, Minas concludes that the 50% discount has overall resulted in a loss of tax revenue.[143]

Sorensen suggests that, in countries where the domestic capital income tax rate is high, there is an increased risk that taxpayers will be attracted to move their assets to low-tax foreign jurisdictions. Applying a low flat tax rate on capital income decreases the incentives for taxpayers to move their wealth abroad.[144] This view has been strongly criticised by some Nordic tax debaters arguing that if residents are taxed on world-wide income, then the source of income is irrelevant. Therefore, the issue of the source-based capital income is less of a concern, so as the residence-based tax, since individuals are less mobile than capital.[145]

A critical consideration is inflation adjustment as capital income can be taxed on the full nominal (including the inflation premium) return, rather than on the real return. If the top marginal tax rate applied to labour income was to be applied to capital income, many types of capital income could be overtaxed.[146] A logical way to mitigate this issue is by applying a low flat tax rate on capital income. In general, the conventional income tax does not accommodate the adjustment for inflation, thereby there might be potential to overtax nominal capital income, according to Sorensen, a DIT system can mitigate this issue and can offer improved equity.[147]

[137] Jukka Pirttila and Haken Selin, 'Income Shifting within a Dual Income Tax System: Evidence from the Finnish Tax Reform of 1993' (2011) 113(1) *The Scandinavian Journal of Economics* 120.
[138] Sorensen, above n 100, 78.
[139] Ibid.
[140] Sorensen, above n 99.
[141] Sorensen, above n 94.
[142] John Minas, 'The Implications of Capital Gains Tax Rate Preferences for Personal Taxpayers in Australia' (PhD Thesis, University of New South Wales, 2017), 49.
[143] Ibid.
[144] Sorensen, above n 100, 78.
[145] Ibid.
[146] Sorensen, above n 99.
[147] Sorensen, above n 100, 78.

Usually, the inflation rate and the nominal interest rate appear to go hand in hand.[148] Consider the case where the nominal interest rate is presumed to be 4% and the inflation rate is 2%, and the top marginal tax on labour is 50%. Nominal interest taxed at the progressive rate at 50% would result in eroding the real interest rate of 2%. However, if a rate of 25% is to be applied on nominal capital income, this would be equivalent to the 50% tax rate on real interest. A tax rate of 25% on nominal capital income could be adequate to align the taxation of real capital income with the taxation of labour income.[149]

To provide a fair assessment of the DIT, both the weaknesses and the strengths of the system should be acknowledged. One of the major issues of the DIT system appears to be the splitting of business income into capital and labour income. Calculating the capital income by using an imputed average rate on the return on business assets can be seen as a crude measure that does not consider the capital's opportunity costs.[150] Another issue in particular while having a low uniform tax rate on all capital income, is that while it can reduce tax arbitrage it also opens possibilities for income shifting by taxpayers from high-taxed labour income into low-taxed capital income exploiting the system. Similarly, Lindhe *et al*. who found that in the Finnish version of the DIT there were some opportunities for the transferring of income, argued that the Finnish version of DIT can distort the owners' financial decisions, due to lower capital rates, compared to Sweden and Norway.[151] An example of this is when the owner managers of a private company transfer their salaries into retained profits, thereby increasing the amount to be taxed as capital income. A possible mooted solution to such manipulation is the introduction of a tax flow-through regime for all business structures and not just for sole proprietors and general partnerships.[152]

Overall, this analysis would suggest that while the Nordic DIT Model could step towards improved tax neutrality, it is incorrect that a DIT removes all the possibilities of tax influencing taxpayers' decisions. For example, clearly the different tax rates applying to capital and labour income are a clear breach of tax neutrality and require integrity rules to ensure that they are not abused. However, the lower tax rate on capital was seen as having the potential to decrease tax arbitrages and planning.

VII.TAX NEUTRALITY AND THE PITCHER PARTNERS DIT MODEL

Pitcher Partners advocated for the introduction of a DIT system, particularly for closely held companies,[153] to reduce the tax rate and structural biases that exist under the current Australian tax system.[154] However, could the model of Pitcher Partners DIT Model achieve greater tax neutrality for the taxation of Australian small businesses?

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[148] Ibid.
[149] Sorensen, above n 94.
[150] Genser, above n 97.
[151] Lindhe, Sodersten and Oberg, above n 108.
[152] Brett Freudenberg, *Tax Flow*-Through *Companies*, CCH-ATTA Doctoral Series No 2, (CCH: Sydney, 2011).
[153] Kokkinos and Sakell, above n 12.
[154] Ibid, 24.

Pitcher Partners DIT Model has a unique feature that differs from the Nordic DIT, that is, the alignment of the top personal tax rate with the corporate tax rate. The purpose of this tax rate equality is to mitigate the distortions of income shifting between labour income and capital income that occur under the Nordic system. The large gap between the top marginal tax rates on labour income and the capital income tax rate can create strong incentives for tax-minimising behaviour. There is evidence that firms' owners may have incentives for income shifting from labour income to capital income. Sorensen points out those controlling and active shareholders may minimise their tax liability by converting management salary into dividends or capital gains from shares.[155]

Theoretically, this alignment of tax rates may offer greater neutrality to the tax system. Unfortunately, there is no evidence to support the practicality of this proposed system, as under the DIT models implemented by the Nordic countries it is generally only the lowest personal tax rate (not the highest) is aligned with both the corporate and capital tax rates. However, Keuschnigg and Dietz proposed for Switzerland, regarding taxation of economic rents, that the top marginal tax rate on earned income to be aligned with the top marginal tax rate on equity returns, with the aim of reducing the incentives for income shifting.[156] While there is no empirical evidence in respect to the equality of the corporate, capital and top personal tax rates, distortions of tax neutrality are most likely to occur as a result of the difference in tax rates. For this reason, it is paramount to analyse this argument from the perspective of the difference in tax rates.

The difference between the top marginal tax rate and the corporate tax rate is of great importance in analysing the distortions to the tax system. There is evidence in the literature to support this view. In the USA, Gordon and Cullen argued that tax aspects can affect the incentives for becoming an entrepreneur due to the differences in tax rates between business income and wage and salary income as well as to the tax treatment of losses.[157] They further argued that it is easier for small business owners to underreport their taxable income than it is for wage and salary earners.[158] The higher the tax rate on the individuals, the more the incentive is to utilise a business structure as a means to avoid tax liability. In respect to entrepreneurs, firms may choose to incorporate in order to avoid high personal tax rates, whereas firms that are likely to incur losses may select to be unincorporated so that losses can be deducted against other personal income.[159] Mackie-Mason and Gordon conclude from their empirical study that there is strong evidence that assets, taxable gains and taxable losses all shift across

[155] Peter B Sorensen, 'Neutral Taxation of Shareholder Income' (2005) 12(6) *International Tax and Public Finance* 777.
[156] Christian Keuschnigg and Martin Dietz, 'A Swiss Dual Income Tax for More Neutrality in Company Taxation' (2004) 140 *Swiss Journal of Economics and Statistics* 483.
[157] Roger Gordon and Julie Cullen, 'Taxes and Entrepreneurial Activity: Theory and Evidence for the US' (Working Paper No 9015, University of Michigan and University of California at San Diego, June 2002).
[158] Ibid.
[159] Ibid.

organisational structures in a way responding to changes in tax rates and tax policy incentives.[160]

Feldstein, who studied the effect of marginal tax rates on taxable income before and after the 1986 USA tax reform, concluded that changes in marginal tax rates prompted taxpayers to alter their behaviour in order to affect taxable income and subsequently tax revenue.[161] The 1986 USA tax reform offers a useful real-world experiment in studying the taxpayers' responsiveness to changes in marginal tax rates. In the 1986 USA tax reform the top marginal tax rate for individuals was reduced from 50% to 28% (similar to the Pitcher Partners proposed model, with the top marginal tax rate to be lowered from 49% to 30% or 27%). The analysis of the Feldstein study demonstrated a significant response in taxable income to changes in the marginal tax rate.[162] In fact, it indicates that sensitivity to tax changes can mean that changes in income tax rates can have less impact on tax revenue, as high marginal tax rates can encourage individuals to obtain part of their wage and salary in forms that are subject to no tax or to a lower tax rate, such as fringe benefits.[163] For example, the Russian experience of lowering the personal marginal tax rates of having one basic rate of 13% for residents; while the 13% rate was a decrease from the previous five rates ranging from 12 to 35%, it also resulted in a 25% increase in individual tax revenue collected.[164] However, the increase in personal income tax revenues was not necessarily caused by the tax reform itself, but there were suggestions that this increase was largely attributed to an increase in real wage rates, and was partially associated with improved tax enforcement and strong energy prices.[165]

USA Studies also provide evidence that taxpayers respond to tax rates changes, when the top individual tax rate was lowered below the corporate tax rate in the 1986 USA tax reform, Auerbach and Slemrod observed that this significantly resulted in a shift in business activity toward pass-through entity which were not subject to corporate tax.[166] Gordon and Slemrod also argue that part of the surge in top individual incomes was caused by the shift of taxable income from corporate sector to the individual sector.[167]

The classical system of taxation in the USA taxes distributed corporate earnings twice, once at the corporate level and again at the individual level, on dividends and realised capital gain from shares. Such a system discriminates against the incorporation of business and can cause a shift

[160] Jeffrey Mackie-Mason and Roger Gordon, 'How Much Do Taxes Discourage Incorporation?' (1997) 52(2) *Journal of Finance* 477.
[161] Martin Feldstein, 'The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act' (1995) 103(3) *Journal of Political Economy* 551.
[162] Ibid.
[163] Ibid.
[164] Alexander Pogorletskiy, Elena Kilinkarova and Nadezhda Bashkirova, 'The Complexity of Tax Simplification: Russia' in The Complexity of Tax Simplification – Experiences from around the world (Edited by Simon James, Adrian Sawyer and Tamer Budak) 2016 *Palgrave Macmillan* 133, 139.
[165] Anna Ivanova, Michael Keen and Alexander Klemm, 'The Russian Flat Tax Reform' (Working Paper No 0516, Fiscal Affairs Department, January 2005).
[166] Alan Auerbach and Joel Slemrod, 'The Economic Effects of the Tax Reform Act of 1986' (1997) 35(2) *Journal of Economic Literature* 589.
[167] Roger Gordon and Joel Slemrod, 'Are Real Responses to Taxes simply income shifting between corporate and personal tax bases?' (Working Paper No 6576, National Bureau of Economic Research, May 1998).

from the corporate to the unincorporated sector and thus adversely affects the economy.[168] For this reason, the USA tax reform had a negative impact on corporate investment. In comparing the classical tax system to the Australian dividend imputation system, the literature agrees that the imputation system in Australia is more effective method to reduce the distortions caused under the classical tax system.[169] Therefore, if behavioural responses to taxation are substantial Saez *et al.* suggest that the optimal policy action would be to broaden the tax base instead of lowering the tax rates and remove avoidance opportunities.[170]

Authors have considered whether the size and growth of unreported income could be explained or linked to high marginal income tax rates. Almost four decades ago, Gutmann stated that 'higher and higher taxes drive more and more of the economy underground, beyond the reach of the tax collector'.[171] Allingham and Sandmo demonstrated that evasion seems to increase with marginal tax rates.[172] Clotfelter studied the effects of tax rates on tax evasion, through the observations of individuals' actual tax return data; the findings suggested that marginal tax rates have a significant impact on the amount of tax evasion.[173] To sum up, evidence appears to suggest that lower marginal tax rates could limit the distortions to the tax system.

The case for an alignment of tax rates correspondingly rests on the experiences of regional countries. For example New Zealand has a closer alignment between the corporate tax rate (28%) and the top personal tax rate (33%).[174] New Zealand also has no general capital gains tax, and currently, the tax on consumption (the GST) is a flat rate of 15% applicable to almost all purchases, excluding financial services and residential rents.[175] In fact, in 2014, the New Zealand tax system was ranked by the USA based Tax Foundation as a leader in the developed world for its individual tax rates and as second for its competitiveness.[176]

Given the prior discussion about the distortion effect of the high marginal tax when compared to the corporate tax rate, the Pitcher Partners DIT model has the potential to offer a more neutral tax system due to the equality between the two tax rates. The Pitcher Partners model also reduce

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[168] Seppo Kari and Jouko Yla-Liedenpohja, 'Classical Corporation Tax as a Global Means of Tax Harmonization' (Working Paper No 665, University of Munich Centre for Economic Studies and the IFO Institute for Economic Research, February 2002).

[169] Ervin Black, Joseph Legoria and Keith Sellers, 'Capital Investment Effects of Dividend Imputation' (2000) 22(2) *Journal of The American Taxation Association* 40; Randall Morck, 'Why some Double Taxation Might Make Sense: The Special Case of Inter-corporate Dividends' (Working Paper Series No 9651, National Bureau of Economic Research, April 2003); Bhavish Jugurath, Mark Stewart and Robert Brooks, 'Dividend Taxation and Corporate Investment: A Comparative Study Between the Classical System and Imputation System of Dividend Taxation in the United States and Australia' (2008) 31 *Review of Quantitative Finance Accounting* 209.

[170] Emmanuel Saez, Joel Slemrod and Seth Giertz, 'The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review' (2012) 50(1) *Journal of Economic Literature* 3.

[171] Peter M Gutmann, 'The Subterranean Economy' (1977) 33(6) *Financial Analysts Journal* 26, 26.

[172] Michael G Allingham and Agnar Sandmo, 'Income Tax Evasion: A Theoretical Analysis' (1972) 1(3-4) *Journal of Public Economics* 323.

[173] Charles Clotfelter, 'Tax Evasion and Tax Rates: An Analysis of Individual Returns' (1983) 65 *The Review of Economics and Statistics* 363.

[174] Money & Taxes in New Zealand, *New Zealand Now* (2016) <https://www.newzealandnow.govt.nz/living-in-nz/money-tax/nz-tax-system>.

[175] Ibid.

[176] Ibid.

the tax incentives; because there would be little tax benefit in income shifting between the labour and capital income, but only up to $312,500.

Further recommendations were made for a simpler system, in regard to reforming the small business CGT concessions. Pitcher Partners argue that these tax amendments could reduce complexity and compliance costs for small businesses.[177] The central point here, of course, is that the arguments of Pitcher Partners are in line with Burton's arguments, who views that preferences and concessions that target specifically small businesses, may not eventually assist small businesses due to the complexity and the distortions they creates.[178] Perhaps, one could argue that many tax reforms for small business can be ill conceived. Nonetheless, the Pitcher Partner Model is built on the concept of the removal of the complicated small business concessions and offering a lower tax rate for small businesses. It can be argued that if the government's intention is to assist small businesses for their disadvantages of being small, this assistance or compensation could be by lowering the tax rates instead of providing a range of tax concessions.

However, for the Pitcher Partner DIT Model to achieve tax neutrality the application of the DIT system to other business structures used by small businesses needs to be addressed. For example, it is not clear how would a DIT model apply to a business utilising a discretionary trust for its business operations.

Overall, there is a possibility that the Pitcher Partners Model could achieve greater tax neutrality between different business structures in Australia. Such potential tax neutrality is due to the equality between the tax rates, but only up to a taxable income of $312,500. Furthermore, from an efficiency perspective, the Pitcher Partners Model may improve efficiency to the tax system by reducing distortions associated with structural choices and financial decisions. From an equity perspective, there could be possible benefits in providing greater equality in tax treatment amongst wage earners and self-employed, corporate and non-corporate small businesses. However, such perceived benefits could be seen only up to a taxable income of $312,500: above that threshold the 45% tax rate can be considered too high. Lastly, from a simplicity perspective, removal of some complex tax concessions and lowering tax rates could reduce complexity and distortions for small businesses.

It is argued that lowering and broadening the capital tax rate under a DIT system was the preferred approach to achieve a more neutral tax system. This was due to efficiencies in tax collections, with a likely reduction in the distortions associated with capital allocation, investment, financial decisions and structural choice.

It is argued that while there is the potential for a DIT to improve tax neutrality for Australian small businesses, greater development of an Australian DIT model needs to occur, otherwise more choices could actually lead to greater distortion and less tax neutrality.

[177] Kokkinos and Sakell, above n 12, 24.
[178] Burton, above n 38.

VIII. RECOMMENDATIONS

Given the prior analysis and evidence from overseas a number of recommendations are put forward for consideration.

If a DIT was to be adopted in Australia, then it is seen as preferable to have these features. Firstly, the splitting of income into capital and labour income should not be mandatory. If no split is opted for, then the marginal tax rates would automatically apply to the business income. If the option to split income is chosen, then the 'gross asset' method is argued as the preferred method given that it appears to be simpler than the 'net asset' method, and this recommendation addresses the regressive compliance cost that can face small businesses. Given the business activity conducted through trusts, it is essential in the Australian context that due regard is given to how a DIT would apply to this business structure as well, and not just closely held corporations, partnerships and sole proprietors. Furthermore, a DIT could necessitate extensive educational programs and changes to accounting software.
However, it is acknowledged that these design features highlight the necessary complexity that seems to be part of a DIT system. It is for these reasons, that two possible alternatives to a DIT are canvassed, beginning with the alignment of tax rates and the introduction of a Business Tax Scheme.

An alternative option for tax reform in Australia: to maintain the principles of comprehensive income taxation and to strength the objective of tax neutrality by broadening the capital tax base, while lowering the marginal tax rates, that is, aligning the top marginal personal tax rates with the current corporate tax rate of 30 percent. To compensate for the loss of tax revenue, it is recommended that the GST rate be increased to 15%. Recommending lower marginal tax rates is in parallel with Ergas's argument that very high marginal tax rates can be very distorting for taxpayers' decisions in relation to their incentive to work, decisions in investments and savings.[179] He also argued that an ideal neutral tax system is where no one pays more than one-third of any marginal dollar in tax, and if a taxpayer earns more for an extra effort that was earned therefore he or she should not be taxed more.[180]

It is argued that the potential benefit from such alignment is the equity in tax treatment between individuals, sole traders, partnerships, trusts and companies. Such alignment could reduce the distortions associated with business structural choice for tax incentives. However, the tax revenue implications need to be closely considered; there may not be the extent of revenue loss due to planning techniques already used by high wealth individuals. Also, it is suggested that equity concerns could be addressed through government expenditure programs rather than the heavy reliance on the progressive marginal tax rate system for individuals.

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[179] Henry Ergas, 'The Inefficiencies in and Distortions Caused by our Tax System' (2011) 46(3) *Taxation in Australia* 94.
[180] Ibid.

An alternative reform to a DIT and alignment of tax rates is for the introduction of a Business Tax Scheme that would see all business income, regardless of structure, taxed at a consistent tax rate. Currently in Denmark under the Business Tax Scheme it is possible for individuals conducting a business as either a sole trader or in a partnership to have their business income taxed at rate equivalent to the corporate tax rate rather than the marginal tax rate. This means that regardless of the structure used to conduct a business an equivalent rate of tax (i.e. 30%) applies. To the extent that the business income is retained for businesses purposes then the corporate tax rate will apply. In the event that the individual withdraws the business income then this withdrawn amount is subject to individual marginal tax rates but with a tax credit given for the prior tax paid at the corporate tax rate (i.e. an imputation system). Such a system in Australia would see greater tax neutrality between different business structures, as well as it would assist with the financing of small businesses as income retained within the business is only subject to corporate tax rate not to the potentially higher marginal tax rates. Consideration should be given as to whether such a system could be extended beyond individuals and partnerships to businesses conducted through trusts.

It is further recommended the removal of some complicated small business concessions. For example, the current small business CGT concessions are more about reducing the tax liability at the end of the life cycle of a business rather than during the life of the business when cash flow can be a critical factor for survival. Lowering the tax rate may compensate for the removal of those concessions and could assist with financing; as small businesses could have more after-tax profit to re-invest back into their business and have a greater ability in employing, thereby, stimulating economic growth. In this way small businesses could benefit and most importantly the complexity could be reduced.

IX. FUTURE RESEARCH

This study provides initial detailed analysis of the DIT system, and future research could build upon this. For example, more work is needed to develop a comprehensive proposal of an Australian DIT model to consider how it could apply to all business structures and in particular discretionary trusts.

Some research should also be expanded on how best to tax companies and shareholders under a DIT system: one approach is no double taxation on dividends and tax on franked dividends is only paid once at the company level; the second approach is no double taxation on Franked dividends to a certain threshold and any amount above the threshold is to be taxed at progressive tax rates.

It could be valuable if further research could be conducted to determine the effectiveness of lowering the top individual marginal tax rates to be more aligned with the corporate and capital tax rates. Also, further research could consider the viability of a DIT system in terms of its implications on complexity and compliance cost for small businesses. Lastly, the issue of how a DIT could influence financing of small businesses should be considered.

X. CONCLUSION

Governments around the world are acutely aware of how their tax system can affect their taxpayers. One area of particular concern is the taxation of small businesses, as they can face a number of challenges due to their size and inherent characteristics. The Australian governments over the years have introduced a number of tax concessions to try to assist small businesses, although their effectiveness is questionable, especially due to the arbitrage that tax concessions can introduce, as well as the integrity provisions that generally accompany them. It has been found that increased complexity does drive up compliance cost for this sector.

There has been concern that in choosing their business structure, that small businesses may unduly be influenced by the differing tax treatment of the available business structure. One possible solution to provide greater tax neutrality is for the introduction of a DIT system, as it theoretically provides greater tax neutrality. This was part of the reason that Pitcher Partners in 2015, advocated for the introduction of a DIT in Australia. This article sought to critically evaluate whether such a DIT would achieve greater tax neutrality.

Firstly, the concept of tax neutrality was discussed, as well as its importance. Secondly, the current small business structures available in Australia were outlined, as well as evidence to demonstrate that tax can be influential in the choice of business structure. Then the history of the DIT system was provided, with an outline of the Nordic DIT, as well as the Pitcher Partner DIT Model. The analysis as to whether greater tax neutrality was evident in both the Nordic and Pitcher Partner DIT systems was provided.

Overall, it was argued that a DIT does have the potential to improve tax neutrality and may remove structural biases that exist in Australia – but more work is needed to develop a comprehensive proposal. In terms of the taxation of businesses, tax neutrality is a design feature that should be strived for, however achieving it is a difficult task, especially when faced with an array of possible business structures that have a variety of legal implications, let alone the tax imposed.