

Limiting Taxpayer Subsidies of Excessive Executive Remuneration, High Risk Business Borrowing and Labour Liabilities Through Business Tax Deductibility Conditions and Limits

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As the Tax Forum considers business taxes while Australia is still suffering the lingering hangover of an inadequately addressed global financial crisis, it is proper to consider how the business tax system might be used to protect taxpayers and government budgets from the high costs of profligate executive remuneration, excessive and reckless business borrowing, and corporate failure to fund full worker entitlements. All of these costs have become more significant as Australia's economy and revenues are threatened by an unbalanced two-speed economy and dangerous global economic volatility.

But before I suggest some tax deductibility changes and limitations for businesses, I need to address the inevitable threats that companies adversely affected by such changes and limitations will likely cart out as part of their objections, e.g., threats about companies moving off shore, closing down or avoiding Australia as a base of operations and losing jobs. I don't buy these threats for a minute.

Decisions about where to set up shop are made far more on the basis of a qualified workforce, production and distribution costs, and political and economic stability of the country. Australia is arguably four-star in at least two of these areas, and its corporate tax rate is competitive.

How can companies rationally argue that limited tax deductibility on their remuneration and borrowing costs forces them to move to a country that encourages them to pay excessive salaries and bonuses and high interest rates? If they can't afford a little less tax deductibility, how can they afford exorbitant remuneration and high interest? And how can they afford to relocate?

I encourage the Forum experts to consider what I suggest without fear of those empty threats and with an open mind. It is easy for experts to dismiss new ideas by coming up with reasons why they can't work. But a true expert will welcome the challenge of thinking how these ideas can be made to work.

Executive Remuneration: Taxpayers subsidise excessive executive and board remuneration packages through tax deductibility of those payments. Given the vehement opposition to such excesses within both the community and government, the Forum should ask the ATO and Treasury how much revenue Australia loses through that deductibility and recommend limits on that deductibility to reflect government and community views on what is appropriate and deserved and what is excessive. Australian taxpayers and governments are well within their rights to say how much they are prepared to subsidise and under what circumstances, without telling companies what to pay their executives and boards.

With this in mind, *I recommend a \$500,000-per-employee cap on tax deductibility of executive remuneration*, including salary, superannuation over the statutory requirement, bonuses, share issues, termination payments, salary sacrifice and perks like private-use cars, personal or family accommodation, gym memberships, school fees, and non-essential office or home renovations.

Such caps have been criticised on the basis that when the US introduced a cap on salaries, other forms of remuneration increased to make up for it. This is not possible in this case because everything a company gives to an executive for personal use, benefit, reward or enjoyment counts as remuneration. Just because an executive wants a gold-plated executive toilet or a car for his wife or an apartment in another city or a weekly flight home, the taxpayer should not be up for 30% of the cost.

Taxpayers get no benefit from a company's largesse to its executives and are perfectly entitled to set a limit on their subsidy of the costs of executive remuneration. Companies can still pay whatever they like, but it comes off their bottom line, not out of taxpayers' pockets. To sweeten this cap for business, fringe benefits tax (and all its administrative nightmares) could be abolished for anyone receiving remuneration more than \$500,000.

I also suggest that top-tier executive and board remuneration not be tax deductible at all after three years of a company's operation if the company is not producing a profit. Three years is enough time for a new company to turn a profit. And older companies with bad balance sheets, high costs, overloaded with debt and under-capitalised should not be rewarding executives who put them in that position or can't get them out of it in three years. Remuneration for CEOs, CIOs, CFOs, Presidents, VPs, Controllers, Treasurers, Group and Divisional GMs, Principals, Chancellors, Vice Chancellors, partners and board members should be tax deductible only for businesses returning a profit.

This requirement ensures highly paid individuals are motivated to create business success, which is good for the economy generally, before taxpayers subsidise their remuneration. If companies elect to operate businesses that only produce losses to minimise taxes elsewhere, then the taxpayer should not be making any contribution to their executive and board remuneration.

A slightly longer exemption might be granted to start-up technology, manufacturing or resource companies that might take a few more years to turn a profit, but deductible executive remuneration after the first three years should be more modest, say, \$100,000 per executive and nothing for board member payments until they produce a profit.

I also think it is reasonable to introduce a new personal tax rate for remuneration above \$500,000. I think this should be \$200,000 plus 50 cents for everything over \$500,000. This represents a modest increase (around \$16,000 or 3%) over the current top marginal rate.

Borrowing: Taxpayers subsidise business borrowings through tax deductions for interest payments. A lot of blame for lingering financial weakness in many companies can be sheeted home to reckless borrowing, but Australian taxpayers are forced to subsidise that borrowing without limits and without any benefit or input. The Forum should ask the ATO and Treasury to quantify what such tax deductions cost Australia's budgets and taxpayers, and set limits and conditions on those deductions.

I base my suggestions on the principles (1) that only businesses that provide goods and services or that are primary producers deserve interest tax deductions, and (2) that such deductions should only be available for interest on borrowings directly related to the core business, not on borrowings for speculative investments outside the core business. The idea is that taxpayers subsidise only borrowings that increase the productive capacity of businesses and contribute to national economic productivity rather than just churn capital through market manipulation and speculation. That churning is what created the false sense of prosperity and growth that inflated real estate and share market bubbles. Therefore, I suggest

- Interest deductions on operational borrowings be capped at a percentage of turnover, say, 10-15%.
- Interest deductions on capital borrowings be limited to investments in income-producing plant, equipment and infrastructure (tangible stuff) or intellectual property.
- No interest deductions for real estate purchases unless the core business is property development or management or real estate trading.
- No interest deductions for investments in shares or financial instruments unless the core business is buying and selling shares and/or financial instruments.
- Interest deductions on borrowings for acquisitions be limited to 12 months, after which borrowings are classed as operational expenses and subject to limitations above.
- All interest deductions be capped at a market rate of interest.

Operational Borrowing: I suggest deductibility of interest on borrowing for operational expenses be capped at a percentage of turnover, to ensure borrowing to cover fixed and variable costs does not exceed the trading value of the business. Such a business would be a bad proposition and should not be operating, but that is a decision for the business to make. But taxpayers should not be subsidising an over-extended enterprise that is undercapitalised and not generating enough income or that is not using its income to cover its expenses. I suggest 10-15% of turnover be the cap, but experts might suggest more.

I base this suggestion on an example that I saw on a PBS TV report on the effect of the credit crisis on small business in America. It illustrated how out-of-whack business thinking had become in an era of cheap credit. A restaurateur was bemoaning the fact that his bank had withdrawn his line of credit, despite him having \$100,000 per week in turnover. He said without the line of credit, he could not pay his staff or buy food for his kitchen. One has to ask what the \$100,000 a week in cash flow was being used for if not to cover his operating expenses. Perhaps to pay for his Porsche and Malibu beach house.

If businesses use credit instead of cash flow to meet their recurring expenses, taxpayers should not reward that borrowing with tax deductibility, apart from what is necessary to smooth out the cash flow of a business. With a cap at my suggested rate for the restaurateur, interest would be deductible on only \$10,000-\$15,000 in weekly borrowings.

Capital Investment: I also suggest that deductibility of interest for capital borrowing be limited to investment in income-producing assets like plant, machinery, infrastructure and intellectual property. Interest on such borrowings should have no deductibility cap, to encourage investment in corporate productivity and competitiveness. Interest on borrowing for company cars should only be deductible for cars used primarily for business purposes and the amount deductible should be capped at the amount necessary to finance a mid-size Australian-made vehicle at the market rate. Companies that can afford to give executives luxury vehicles or pay exorbitant interest rates can absorb the extra interest costs far better than taxpayers can.

Speculative Investment: Interest tax deductibility should not be extended to business borrowings for speculative investments in shares and financial instruments unless such investments are the core business of the enterprise. Such investments remove from a business funds that may be better spent on plant, training, marketing, innovation or improving productivity. They do not grow the economy or jobs but merely churn capital, or as recent history has taught us, destroy businesses and investors. They are not part of the core business to which tax deductibility is granted. If companies want to pursue such investments, they can set up discrete entities to do so, which may then give them tax deductibility entitlements but without endangering the productive core enterprise.

Real Estate: Interest on borrowings to purchase real estate should not be tax deductible unless one is a property, farming or mining business. It is a general principle of business that, to preserve capital and increase tax deductions, a business does not buy a building that it can lease. Like investments in the market or financial instruments, buying real estate unnecessarily sucks productive capital out of a business, and it is not part of the core business to which tax deductibility is granted. Again, if a business wants to buy real estate, it can set up a discrete entity for this purpose and claim tax deductibility. Small businesses should not be able to deduct interest for mortgages on home offices or business premises in which they live.

Acquisitions: I suggest deductibility of interest for acquisitions be limited to 12 months, which gives the company time to integrate the acquisition. After that time, any interest payable on the acquisition loan should be paid out of the cash flow the acquisition generates and should be treated as an operational expense subject to limits outlined above. If you buy a business that isn't going to produce enough cash flow to cover your interest costs and any increases in fixed and variable costs, then it is a bad acquisition. The government can't stop businesses making bad acquisitions, but it can stop taxpayers subsidising them indefinitely.

Market Rates: We have learned from the GFC that many companies borrowed too much at rates they couldn't afford, and lending institutions were pretty slack in assessing companies' ability to repay loans. As a result, lending institutions are now more risk averse and charge premium interest rates on risky business lending. Taxpayers should not have to subsidise the higher interest costs of risky borrowing.

I suggest that tax deductions for business borrowing be capped at the average market rate for low-risk business borrowing. If companies have to pay higher interest rates because they are more financially risky, taxpayers should not reward their risk-taking by allowing more generous deductions than companies more financially sound or cautious receive. Taxpayers should not subsidise risky investments or marginal businesses more than it subsidises quality businesses borrowing sensibly for good reasons. Hence the cap on deductible interest rates. And lenders do the risk assessment, which is reflected in the interest rate charged, so the ATO doesn't have to make any complex judgements about business risk.

The same cap on deductible interest rates should apply to personal tax deductions for real estate and share market investors. Interest deductions for investment properties or shares should be capped at 50 points above the average variable mortgage rate. Foolish personal investors who take out loans at high interest rates to speculate in the market or on real estate should not be subsidised by taxpayers.

Labour Liabilities: When companies fail to put aside money for their contractual and award obligations to ordinary workers -- e.g., holiday and sick pay, long service leave, redundancies and super -- taxpayers pick up the tab through the government redundancy fund, Centrelink benefits and pensions. The government must protect taxpayers from such obligations.

I suggest that the tax deductibility of any labour costs be contingent on full payment of all workers' entitlements, as they accrue, into an Employee Benefits Trust not under the business' control, and all workers' super entitlements into an approved fund. Without evidence of having paid all such worker entitlements to an appropriate fund, no tax deductions for labour costs should be claimable.

The government may also want to set up an ATO master trust into which small businesses can deposit their entitlements through the PAYE system. Governments should also refuse to trade with any business that is not fully paid up on its employee entitlements.

Companies are quick to claim they cannot possibly afford to put aside funding for their contractual and award obligations to ordinary workers, yet they insist they must meet their contractual obligations to pay multimillion-dollar bonuses and termination payments, even to executives who have driven the company into a ditch. Too many companies will not do the right thing until they are forced to. And small businesses that complain about how this will affect their cash flow are precisely the businesses most likely to dud their workers if the business goes belly up. I'm sure business will find tax deductibility of labour costs too valuable to risk by avoiding their obligations to workers. And this does not add one cent to the cost of labour. It only pays workers what they are due.

Making the tax deductibility of labour costs contingent on fully funding employee entitlements is taxpayer protection and also simple good business. If a business cannot meet its full financial obligations to its workers, it should not have workers. It is not the employees' responsibility to fund the employer just to have a job. That's indentured servitude. The idea that workers should put at risk their entitlements for no benefit is another form of servitude. Employers are using employees' funds without their consent or benefit.

An Employee Benefits Trust and better ATO monitoring of statutory superannuation contributions will provide valuable protection for taxpayers and workers while teaching companies to be responsible to their workers.