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Company tax cuts: An Australian gift to the US Internal Revenue Service

How a cut to the Australian company tax rate would result in a windfall for the United States Treasury

Briefing paper

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Introduction

One of the poorly understood impacts of a company tax cut is that there is little benefit to domestic investors because the way that company tax payments are credited against the tax payable by Australian owners of companies. The system of crediting company tax paid against the income tax liability of shareholders is known as 'dividend imputation'.

Under dividend imputation company tax is treated as a pre-payment of the tax ultimately payable by the domestic owner of the company. The domestic owner has to pay personal income tax according to the normal tax scale. But company tax paid before dividends are distributed is treated as an offset against any personal tax liability. Any saving from a company tax cut is nullified by a reduction in the offset received by the domestic investor. Hence a cut in the company tax rate from 30 per cent (28.5 per cent for small business) to 25 per cent increases the amount available for the company to pay out in dividends but reduces the franking credits that domestic taxpayers can apply against their personal tax liability.

There is, however, one important exception to this rule. The tax offsets (franking credits) can only be used to reduce tax payable to the Australian government and, in turn, are worthless to foreign owners of Australian companies. Put another way, the only potential beneficiaries of a cut to the Australian company tax rate are foreign shareholders. But even that is not the whole story.

How the US Internal Revenue Service benefits from cutting Australian company taxes

The US is the largest foreign investor in Australia accounting for 27 per cent of all foreign investment. By contrast China comes accounts for just 2.3 per cent of foreign investment in Australia.

While Australian shareholders who 'benefit' from company tax cuts simply end up paying more personal tax it is important to note that the existence of 'bi-lateral tax treaties' between Australia and other countries (such as the US) mean that a reduction in Australian company tax does not necessarily result in a reduction in company tax paid by foreign companies and can simply result in an increase in the tax paid by foreign companies to foreign governments.

Foreign companies have to pay tax in their place of residence and that complicates matters. Under the various foreign tax treaties with Australia, a tax paid on one jurisdiction can be used as an offset against tax payable in the home country. Hence US companies receive a tax credit for tax paid in Australia which they can apply against their US tax. That can mean the foreign investors themselves most likely obtain no benefit from any reduction in Australian company tax; it just increases the US tax.

To illustrate, suppose a US company earns $100 in Australia and pays company tax of $30. When filing its US tax return it declares income of $100 and claims an offset for the $30 paid in Australia. The present US company tax rate is 35 per cent.[1] Hence the US company will be taxed $35 in the US and receive a $30 credit. But if the Australian company tax were to fall to 25 per cent then the Australian tax would be $25, the US tax $35 but with a credit for the $25 per cent leaving $10 payable to the US IRS by the US company. Hence in this case, any tax cut going to the US company increases its US tax liability and the US company is no better off. The beneficiary is of course the US Internal Revenue Service.

We now turn to consider how large is the likely gift from Australia's tax office to the US IRS. The US IRS publishes details of the company tax claims and collections and from that the following table has been constructed. In column 2 we present the number of returns filed claiming credit for Australian tax paid. Column 3 gives the gross income claimed from Australia on the part of US companies and column 4 gives the taxable income. Column 5 gives the amounts claimed as Australian taxes paid, accrued, or deemed to have been paid. Because the amounts are volatile, a four year series it presented in Table 1.

Table 1: American companies claiming credit in the US for taxes in Australia

Tax year	Number of returns claiming credit for Australian tax paid	Gross income (less loss)	Taxable income (less loss) before adjustments	Australian taxes paid, accrued, and deemed paid
		US$ million	US$ million	US$ million
2012	736	24,005	14,206	2,968
2011	706	23,110	13,838	3,142
2010	663	24,066	13,926	3,451
2009	619	19,080	11,293	2,121

Source: (US) Internal Revenue Service (2016) *Tax Statistics*, at https://www.irs.gov/uac/Tax-Stats-2 accessed 9 May.

The US data includes not only company tax paid in Australia by American companies but also most likely includes other taxes such as withholding taxes levied on foreign companies on interest payments and some dividend payments to parent or other

[1] Deloitte (2016) Corporate tax rates 2016 https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-corporate-tax-rates.pdf US companies may also be subject to state taxation.

related American companies.[2] Given the magnitudes involved for withholding taxes are relatively small[3] we think that it would be a conservative assumption to assume that 80 per cent of the value of Australian taxes paid, accrued and deemed paid would involve company tax paid in Australia. On that basis and using the average for the four years presented in Table 1 it will be assumed that a reasonable estimate for the tax credit claimed on Australian company tax paid in 2026-27 will be the average of the figures in column 5 updated according to the actual and expected growth in nominal GDP.[4]

Using the assumptions outlined here we estimate that when the full company tax cuts are implemented in 2026-27 the Australian taxpayers will be making a gift of US$732 million pa to the US government. Over the decade beginning in 2026-27 there would be a gift of US$8.07 billion to the US government.

All the figuring so far has relied on US sources and so has been expressed in US dollars. Converting our main conclusions into Australian dollars[5] our findings are that we find that in 2026-27 Australia will give a gift to the US of A$999 million and A$11.01 billion over the decade beginning in 2026-27.

It gets worse

If Australian governments are successful in addressing multinational tax avoidance that involves third countries as tax havens, then the estimates here would understate the full value of the gift to the US government. By tackling multinational tax avoidance via third country transactions more taxable income would be assessed in Australia but if the company tax rate is reduced then much of the benefit of identifying assessable income would be lost with lower tax rates. However, the benefit of the lower Australian tax credits would be captured by the US IRS as it levies tax on multinationals but gives a smaller credit for tax paid in Australia.

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[2] The Australian withholding tax is levied on incomes paid abroad to reflect tax that would have otherwise been paid by domestic residents had they received the income. Interest payable abroad and unfranked dividends (on which no company tax has been paid) tend to attract the withholding tax on payments made between Australian and foreign residents.

[3] For example from Table 1 we know that of the US$2,968 million in tax paid in Australia, only US$159 million involved tax on interest payments. The latter amount is assumed to be withholding tax.

[4] Actual nominal GDP to 2014-15 is obtained from ABS (2015) *Australian System of National Accounts, 2014-15*, Cat no 5204.0, 30 October and later years rely on Budget forecasts and projects using Australian Government (2016) ‘Budget paper no 1’, *Budget 2016-17*.

[5] At the Reserve Bank of Australia quotation of A$1 = US$0.7328 at 10 May.

In the 2016 budget Treasurer Morison announced a plan to crack down on multinational tax avoidance with more resources for the Australian Tax Office. If, as the budget papers predict, the Australian government is successful in addressing multinational tax avoidance involving third countries as tax havens, then the size of the gift from the Australian people to the US IRS would be bigger still. Consider the following example:

A US coal mining company is reducing its 'Australian profits' by paying high 'marketing fees' to its Singaporean subsidiary. These high fees reduce the profit (and tax payable) on its 'Australian operation' and increase the profit generated from selling coal via the low tax 'Singaporean operation'.

After a crackdown on such 'transfer pricing' the Australian profit of the US coal company increases and the US tax payable on that higher profit will also increase even if the Australian company tax rate falls from 30 per cent to 25 per cent.

In effect, the extra money spent by the Australian ATO will boost the tax revenue collected by the US government.