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U.S. Tax Reform Reaches Across the Pacific: How will Australia Respond?

Melinda Peters and Alex Whitney
McCullough Robertson, Australia

For as long as Donald Trump's general views on U.S. tax reform have been publicized (in particular, his desire to slash the corporate tax rate), Australian commentators and politicians have speculated as to how the changes will impact Australia's economy and our own (somewhat stagnant) tax reform process.

Melinda Peters and Alex Whitney are Lawyers at McCullough Robertson, Australia

However, with the U.S. tax reform bills now passing through Congress and the Senate, and the final reconciliation bill now having passed through Congress, discussion in Australia has refocussed on tax reform, with two key, and somewhat interrelated, considerations firmly in the spotlight—will U.S. tax reform hurt the Australian economy and/or its attraction as an investment destination and, does the U.S. tax reform add even greater impetus, for a reduction in the Australian corporate tax rate?

Context

Reduction of the Australian company tax rate has been a central issue for debate in Australian politics since at least the current Liberal Party leader, Prime Minister Turnbull came to power in 2015. Prior to the 2015–16 income tax year, Australia taxed all companies at a flat rate of 30 percent (currently 5 percent above the OECD average). In the 2015–16 year, the government successfully legislated to reduce the corporate tax rate to 28.5 percent for "small business entities" (i.e. companies with an annual turnover of AU$2 million or less).

In the 2016–17 year, small business entity tax rate was further reduced to 27.5 percent and the turnover threshold increased to AU$10 million, expanding access to the reduced rates. Under the current proposal, the threshold will increase to A$50 million from July 1, 2018, and the rate progressively reducing further to 25 percent over the next eight years. This graduated introduction has frustrated tax practitioners and businesses, as it further complicates a number of tax issues—not least of all the fact that it introduces a number of additional categories of companies within the (already complicated) Australian tax legislation, and impacts the operation of Australia's dividend imputation system.

The current Turnbull government hopes to further reduce the corporate tax rate for all companies to a flat 25 percent. However, this goal has to date been stymied by efforts of the Australian Labor Party (a center-left party with strong union ties), together with the Greens party and several other minor parties.

In contrast, the government's view has always been that Australia needs to reduce its corporate tax rate to remain competitive globally and ensure Australia remains attractive to foreign investors in light of the global trend of decreasing corporate tax rates (including within the Asia Pacific region).

The U.S. tax reform initiatives and reduction in corporate tax rate has presented an opportunity for the Liberal Party to bring the issue back to the top of the agenda. In particular, the Treasurer Scott Morrison and Prime Minister Turnbull have been very vocal about the need for Australia to bring its corporate tax rate down to a "competitive" level.

Impact of U.S. Tax Reform in Australia

The progress of the U.S. tax reform bills that the Republican Party has achieved has triggered a flurry speculation in Australia as to what U.S. tax reform will really mean for us.

Those Australian businesses that have operations in the U.S. or are looking to establish a base in the U.S. for export are likely to benefit greatly from the U.S. tax reform measures. However, businesses exporting from Australia to the U.S. may find the proposed U.S. changes have a significant impact on their operations—particularly where they do not have an operational base in the U.S.

Economists and the government have each weighed in on what they see to be the main impacts on the Australian economy and tax reform proposals and how Australia should respond, with Treasury recently issuing a discussion paper on these issues.

The Treasury Paper sets out the government's view as to how the U.S. tax reform measures will impact global trade. While it does not focus on the impact within Australia it presents an important insight as to the Australian government's view on how to deal with U.S. tax reform. The Treasury Paper's central concern is that the expected result of U.S. tax reform is to drive domestic growth and investment in the U.S. As global investment is (in some ways) a zero-sum game, investment in the U.S. presumably means the diversion of foreign capital away from international jurisdictions (including Australia) and towards the U.S.

Importantly, the Treasury Paper considers two possible outcomes for Australian industry from the U.S. tax reform process—the U.S. sourcing all goods and funds domestically, and the alternative, in which goods and funds must be sourced internationally. The latter scenario presents some hope for Australia—particularly given its status as a major producer in the resources sector of primary materials such as iron ore and coal which are relatively immobile (although historically these are commodities that generally head to Asian rather than American markets). However, it is those industries which are less dependent on fixed location and resources that are likely to feel the impact of, not just the U.S. tax reform changes, but also the relatively higher corporate tax rate in Australia as compared to other OECD countries.

The conclusion reached by the Treasury appears to be that if the U.S. tax reform programme has the desired effect of increasing U.S. domestic investment, Australia will have to take steps to remain competitive in a global market, a sentiment obviously echoed by the Turnbull government and commentators.

The Push for Lower Tax in Australia

The Liberal Party has, for some time, been pushing to introduce a gradual reduction of the corporate tax rate in Australia to 25 percent for all corporate entities.

There are a number of problems with this goal. Chiefly, the Liberal Party is the only major party that seeks a global reduction of the corporate tax rate. While the Labor Party and other minor parties have demonstrated willingness to provide tax relief to small businesses, any attempt to cut taxes for the 'big end' of town (particularly given current public and political sentiment, whether or not correct, that large corporates are not paying their "fair share" of tax in Australia) is deeply unpopular amongst segments of the Australian population.

However, other legal problems also plague attempts to reduce corporate tax rates in Australia. Firstly, it is important to note that a large number of Australian businesses (generally small businesses) do not operate in a corporate structure—either employing trust structures, partnerships or operating under their own name. Secondly, a huge proportion of companies in Australia derive passive investment income, and there have already been significant legislative difficulties in ensuring that any reduced corporate tax rate is only received by businesses that are active (the crux of the argument for a lower tax rate being that the reduced corporate tax rate will free up capital to allow businesses to invest in their business operations or take on more employees). In a way, the corporate tax rate has been conflated with a business tax rate when in reality not all companies run businesses and not all businesses are companies.

Politically, it is also likely to be extremely difficult for Australia to pass legislation reducing the corporate tax rate in the near future. The government's legislative plans have recently been derailed by the (actual or potential) disqualification of a large number of senators and members of Parliament due to those members and senators holding dual citizenship, as well as the postal survey on marriage equality and the subsequent time and effort directed towards the passing the marriage equality legislation.

In light of all of these issues, it seems unlikely that Australia will either reduce its corporate tax rate further, or extend the corporate tax rate reductions to all companies, in the near future.

Does Australia Really Need a Corporate Tax Cut?

In light of the current political climate and U.S. tax reform measures, it is important to question whether Australia really needs to further reduce its corporate tax rate and what, if any, effect this is likely to have on the Australian economy.

When it comes to attracting capital, Australia's tax rate has always been only one of a number of key factors. Often more important than the tax rate is Australia educated population, high level of urban density, significant wealth of resources, stable government and robust rule of law. Australia does not (and practically cannot) complete with the likes of Singapore or Hong Kong as a center of capital, rather Australia's value as a destination for investment comes from its other advantages.

Further, Australia is already taking real steps to ease the inbound flow of capital—including by introducing structures and concessional tax regimes for foreign investment into passive assets. There are also a range of other concessions available which can further reduce a foreign investor's effective tax rate in Australia. Australia's system of R&D tax offsets is a generous system that rewards research and development activities in Australia and can bring the effective tax rate of an international player in Australia to a rate potentially much lower than the headline corporate tax rate. Venture capital and early stage innovation company tax incentives can also operate to reduce the tax that a foreign investor may pay in Australia. Each of these measures also has the added effect of stimulating investment and growth in Australian technology sectors.

There are still areas of improvement for Australia in attracting foreign investment. Foreign investment regulatory requirements, State based taxes for foreign investors and other regulatory issues can make investments in Australia more complex and costly for offshore entities—with the current difficulty in legislating broad scale corporate tax rate cuts, it may be worthwhile to consider if these other impediments could be eased or lifted.

U.S. Tax Reform—Still a Wait and See in Australia

Although, due to a lack of political momentum, it seems unlikely that Australia will follow the U.S. and reduce its corporate tax rates in the near future, the impact of reduced U.S. corporate tax rates may impact Australia less than other financial capitals in the region such as Singapore and Hong Kong, given that Australia still has significant non-tax advantages when it comes to the competition for international capital investment.

However, to ensure Australia remains attractive for foreign owned businesses investing and operating in Australia, we do need to consider the effect that our corporate tax rate has on the broader economy political and taxation landscape. The public perception that multinationals should pay their "fair share" of tax in Australia and the resulting higher headline corporate tax rate for large companies may in fact encourage the maximization of concessions and deductions available in Australia and incentivize the movement of profits offshore to lower tax jurisdictions.

Melinda Peters and Alex Whitney are Lawyers at McCullough Robertson, Australia.

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