Submission to Senate Economics Committee Inquiry into Corporate Tax Avoidance

19 April 2017

Michael Potter, Research Fellow, the Centre for Independent Studies (CIS)

THE CENTRE FOR INDEPENDENT STUDIES

Submission to Senate Economics Committee Inquiry into Corporate Tax Avoidance

The Centre for Independent Studies (CIS) welcomes the opportunity to make a submission to this Inquiry.

Corporate tax avoidance is an issue of some concern to the Australian community. However, many assertions made in the debate about tax avoidance are not supported by evidence; such as statements that company tax avoidance is widespread.[1] This submission reviews some of the relevant evidence and the arguments surrounding that evidence.

This submission focusses on the following parts of the Inquiry's Terms of Reference: "tax avoidance and aggressive minimisation by corporations registered in Australia and multinational corporations operating in Australia with specific reference to (a) the adequacy of Australia's current laws… and (h) any other related matters".[2]

In summary, this submission argues:

- There is no clear-cut evidence of widespread tax avoidance or minimisation under Australia's current laws, with several measures showing company tax revenue is above historical averages and developed world averages.
    - This is supported by early reports of the ATO's tax gap analysis, and the share of tax paid by the largest corporations.
- The figures on tax payments by individual companies are not particularly informative about supposed tax avoidance, as there are numerous good reasons why specific companies can have low or zero tax payments, and why many companies pay an effective rate below the statutory rate of 30%.
- On this basis, there is no clear problem with the adequacy of Australia's corporate tax laws.
- Nevertheless, there are risks of increased corporate tax minimisation in coming decades, but there is very little that can be done about this.
- Supposed tax avoidance is not a reasonable justification for the rejection of proposed corporate tax cuts.

Analysis of total tax revenue from companies

Overall company tax revenue in Australia is high by comparison with other developed countries, and is above historical averages.

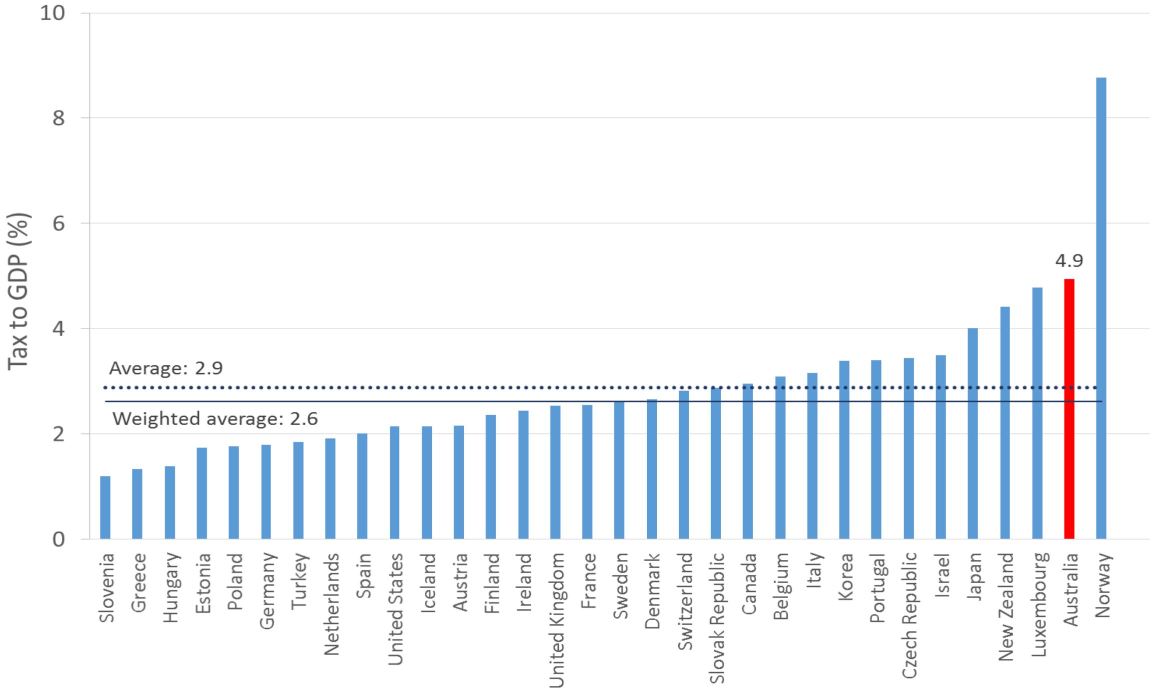
It is sometimes argued that Australia's imputation system means international comparisons of company tax should be downplayed or disregarded.[3] This argument is not correct. Imputation prevents double taxation of dividends for Australian residents only, and has negligible effect on foreign investors.[4] Therefore, imputation is not relevant to international investors, and international comparisons are, unsurprisingly, most relevant to these international investors.

Further discussion on franking and international comparisons is in the related CIS publication, *Fix it or Fail: Why we must cut company tax now*.[5]

Ratio of corporate tax revenue to GDP

The first measure of corporate tax payments is the ratio of tax to GDP. The data for 2013 is shown in Figure 1. According to OECD data, Australia's company tax to GDP ratio is 4.9%, second highest of the 32 countries included in the data, and Australia has been second or third highest since 2006.[6] Australia's figure is well above the OECD weighted average of 2.6% (the arguments for using a weighted average in preference to a simple average are covered in a related CIS publication[7]).

Figure 1: Company tax to GDP ratio in OECD in 2013

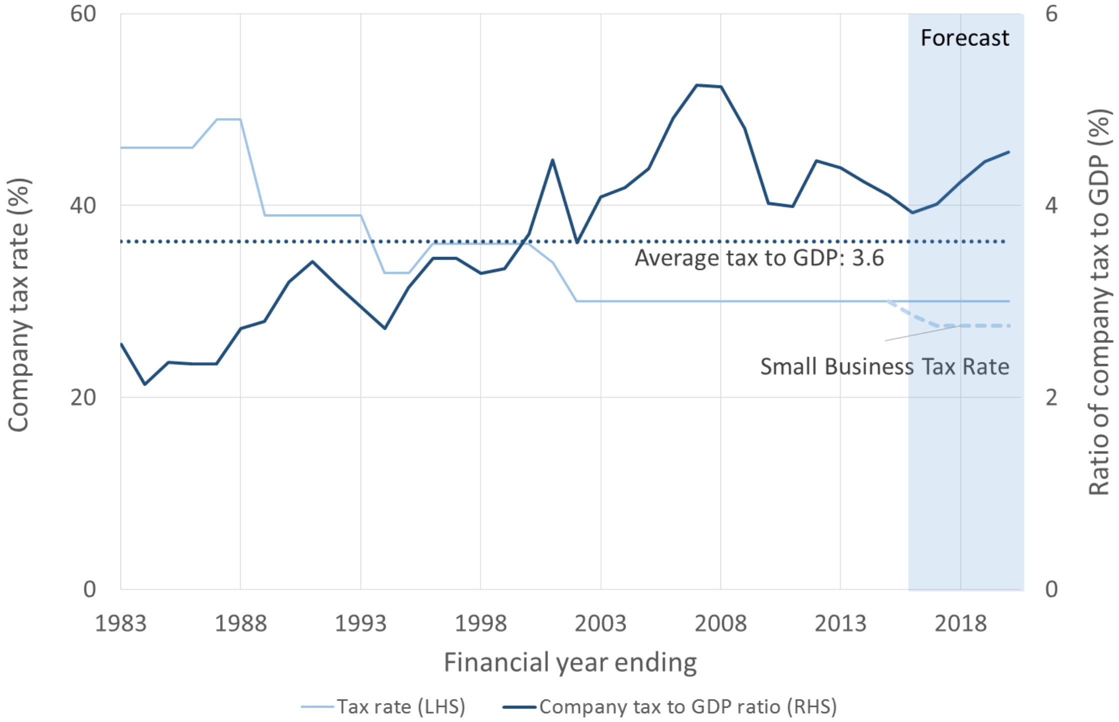


Source: Potter (2016).[8] Figures are for 2013.

Australia's company tax to GDP ratio is about 3.6% when rent taxes *and* imputation credits are removed,[9] still well above average, even though the arguments for removing imputation are dubious as noted earlier.[10]

The corporate tax to GDP ratio is currently above its historical average, and has increased substantially since 1983 even though the corporate tax rate has declined substantially since then. This is shown in Figure 2.

Figure 2: Company tax to GDP ratio for Australia — history and forecasts



Source: Potter (2016)[11]

Similar results have occurred in other OECD countries: company tax revenue has actually increased as a share of GDP after the tax rate was cut in the United Kingdom, Canada, Ireland and New Zealand.[12]

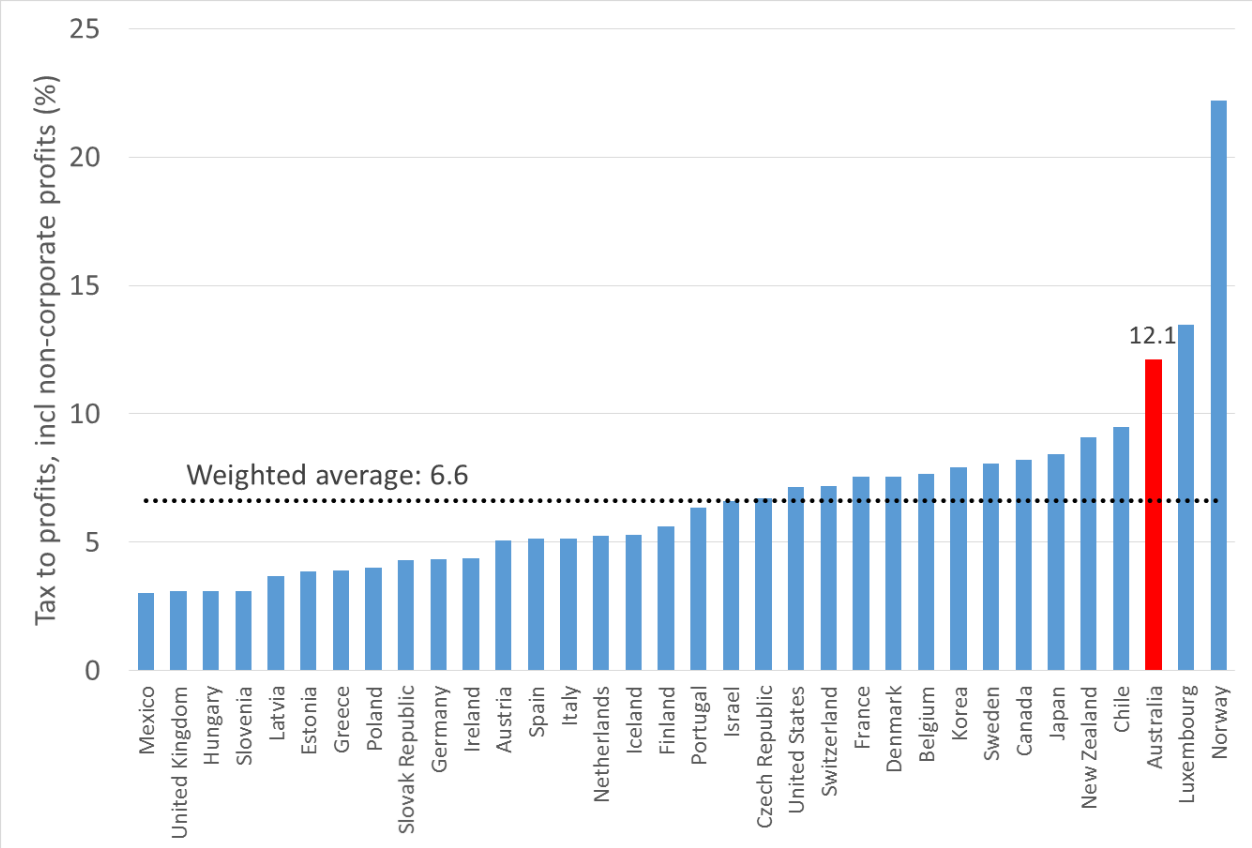
This means that tax reductions do not automatically mean lower tax revenue. Tax revenue can go up, particularly when accompanied by changes to broaden the tax base. The increase in revenue also supports the case that the cost of tax reductions can be, in part, recouped by the growth benefits of lower taxes.

Ratio of corporate tax revenue to profit (effective tax rate)

The effective tax rate is broadly the ratio of aggregate tax paid to aggregate company profits. As the tax to GDP ratio is affected by unrelated factors that have increased corporate profits, such as increased incorporation or an increased capital share of income, the effective tax rate is a better measure of overall tax burden.

Data from the OECD does not separately report on profit of companies only: it has figures on profit of companies *plus* unincorporated businesses.[13] So the OECD measure of the effective corporate tax rate includes non-corporate profits in the denominator; as a result this is an imperfect measure. Noting this data issue, the effective tax rate is shown in Figure 3.

Figure 3: Corporate tax to profits (incl non-corporate profits) ratio



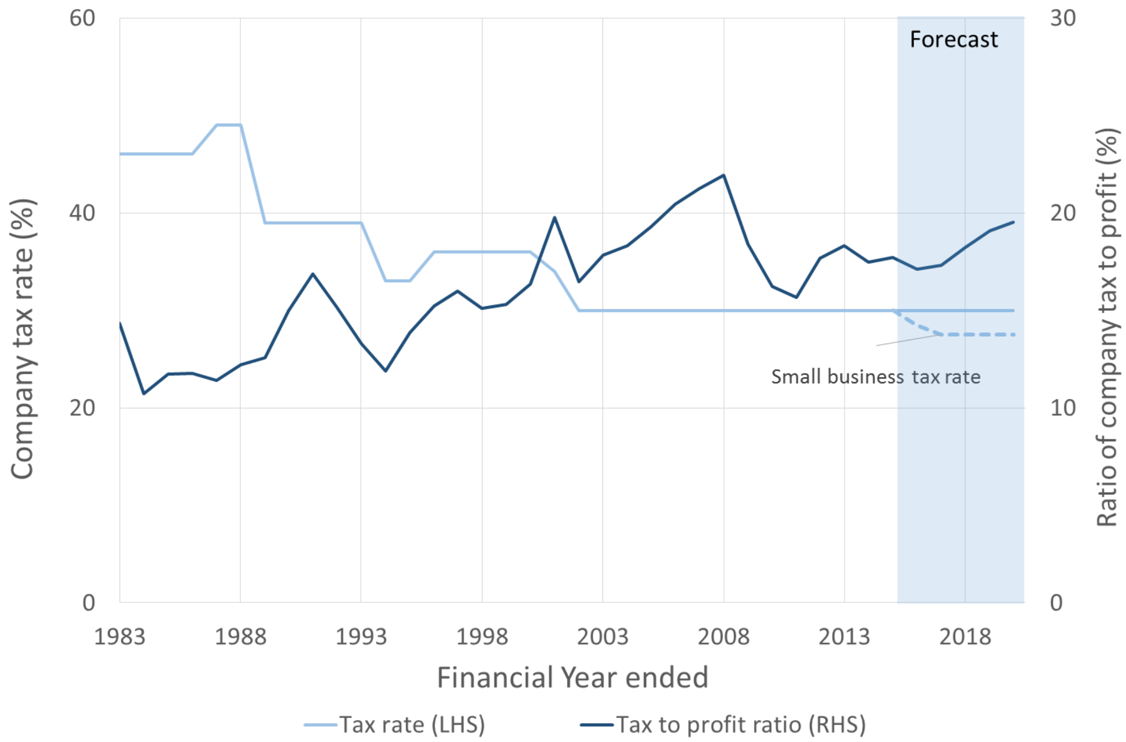
Source: OECD.[14]

As the data in Figure 3 includes profits of unincorporated business, it should be treated with caution. However, the conclusion that the effective tax rate in Australia is well above the average is supported by a several other comparisons.

- A report for the US Business Roundtable by PriceWaterhouse Coopers found the effective tax rate for companies headquartered in Australia was 27.1% from 2006–2009, which is fifth-highest of the 28 surveyed countries and well above the average of 22.8%.[15]
- The World Bank's *Doing Business* report for 2016 found the profit tax rate (which measures the tax on profits as a percentage of commercial profit) for Australia is 26%, which is well above the world average (16.2%), the EU/EFTA average (12.6%), non-EU OECD average (16.1%), and the Asia-Pacific average (17.6%).[16]
- A report for the Minerals Council of Australia found Australia has one of the highest marginal effective tax rates on investment (tax paid as a share of pre-tax rate of return on capital) among the OECD, as well as among a larger sample of 45 countries. From 2005 to 2015, Australia's effective tax rate moved from 10th highest to 4th highest in the OECD.[17]

We can calculate the effective corporate tax rate for Australia over time, because Australian data does separate out corporate and non-corporate profits. This is shown in Figure 4.

Figure 4: Corporate effective tax rate for Australia — history and forecasts



Source: Potter (2016).[18]

Based on this data, we can say that Australia's effective corporate tax rate has been increasing over time. There have been fluctuations around this long-run trend, particularly due to the Global Financial Crisis. This trend is explained by the same factors that explain the trend in the ratio of tax to GDP, including changes to broaden the tax base, and partial recoupment of the costs of corporate tax cuts.

Conclusions from economy-wide data on corporate tax

Tax paid by Australian companies is well above average for the developed world, even when the debatable adjustment is made to remove imputation from the calculations. This means Australian companies, on average, have a higher tax burden imposed on them than companies in other developed countries. If there is a tax avoidance problem in the OECD, it affects other developed countries much more than Australia.

The tax burden on Australian companies has been increasing over time. While this reflects a number of factors, it directly contradicts the argument that there is a growing issue with corporate tax avoidance. On average, Australian companies are paying a greater share of their profit in tax over time, not a lower share.

This is supported by arguments from the ATO itself, which has not supported claims of widespread corporate tax avoidance, instead stating "A suite of indicators generally suggests companies are paying the income tax required under Australia's tax laws. Tax risk appetite has declined over the past decade."[19]

Tax gap analysis

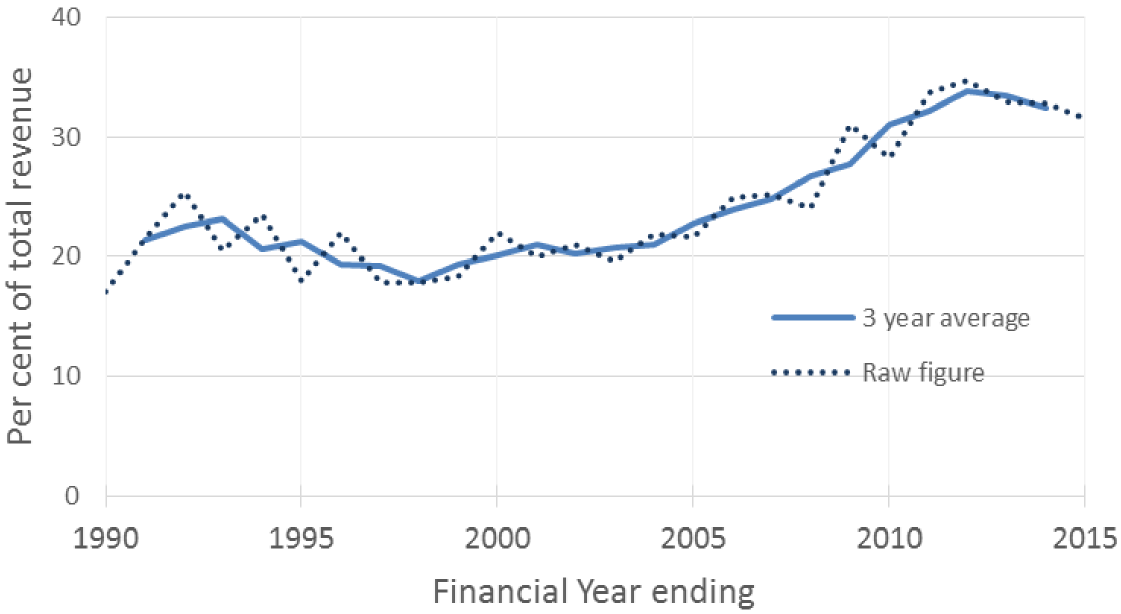
The Australian Taxation Office (ATO) is developing estimates of the tax gap for various taxes. This measure is of the difference between what is actually paid in tax and what the ATO considers would be paid if every taxpayer was fully compliant.[20] The ATO has already published tax gap estimates for several taxes; for example, the estimated tax gap for fuel excise is $0.1bn for 2016–16 or 0.8% of revenue.[21]

The company tax gap figures are still under development. However, the ATO has reportedly stated that the tax gap for corporate tax is "relatively modest" and the largest tax gap is with personal tax.[22] As a consequence, any argument that there is rampant corporate tax avoidance is not supported.

Share of tax paid by largest corporates

The evidence also indicates that tax payments by the largest companies in Australia are growing over time. The top 12 companies paid just under one third of all company tax revenue in 2014–15, a substantial increase from the proportion of around one fifth in the 1990s, as shown in Figure 5.

Figure 5: Proportion of company tax revenue paid by largest 12 taxpayers



Source: Potter (2016), ATO Corporate Tax Transparency Report 2014–15.[23]

The recent declines in this share are likely caused by the end of the mining boom. However, the share of the top 12 taxpayers remains well above historical levels: The average for the 1990s was 20.2%; the average for 2000s was 23.1% and the average during the current decade so far has been 32.4%.[24]

This shows that the largest taxpayers are bearing an increasing share of the overall corporate tax burden, and no clear trend for increasing tax avoidance from this group.

However, this does not necessarily mean that tax payments always increase for the largest taxpayers. Instead, the largest companies experience substantial fluctuations in tax payments. In particular, BHP Billiton paid $3.95bn in tax in 2013–14 but $1.72bn in tax the following year. This is a decline in tax payments of $2.2bn or 57% in one year. This does not necessarily mean a large increase in tax avoidance by BHP in 2014–15, as BHP's tax rate (ratio of tax paid to taxable income) was only slightly below 30% in both years. [25]

These sizable fluctuations in tax payments show the sensitivity of tax revenue to the performance of individual companies. A bad year for just one of these companies can create a major problem for the Budget. This also shows the risks to the tax system if one or more of these largest companies leave Australia. While such a departure is currently very unlikely, there is a risk that one or more of these companies may be driven to relocate offshore if the gap to other tax rates becomes too great. This is discussed further in the section on the future of tax avoidance.

Does tax avoidance argue against tax cuts?

In the debate over the corporate tax cuts, a frequent argument is that the tax cut should not go ahead because of corporate tax avoidance.[26] But this is effectively saying the taxpaying businesses are collectively responsible for the alleged tax avoidance of other unrelated businesses. Tax avoidance by one business means the rejection of tax cuts for other businesses. It is hard to see why this is a good approach to public policy. Collective responsibility for the actions of others is surely an out of date philosophy in the twenty-first century.

But the problems with this argument don't end there. Higher taxes because of tax avoidance would actually *worsen* the problem. The evidence clearly indicates that the incentives to engage in tax avoidance are larger when rates are higher.[27] There is little dispute that higher tax rates encourage more tax avoidance; debates appear to be more about the degree of extra avoidance encouraged by high tax rates.

In addition, the evidence earlier in this submission shows that Australian corporate tax payments are above historical averages, and above developed world averages. This means that if avoidance is an issue, then this should be a problem with who is contributing to the overall tax burden, not the size of the overall burden. Similarly, if some companies are not paying the appropriate share of the total tax burden (whatever that may mean), then this does not mean that the overall burden should go up — instead, the distribution of the burden needs changing.

As a result, any additional revenue from addressing tax avoidance should result in lower taxes on other companies, ensuring the overall tax burden does not increase further above its historical average.

Tax payments by individual companies

The data on total company tax revenue (considered above) does not indicate a major problem with tax avoidance. However, the ATO's corporate tax transparency report for the financial years ending 2014 and 2015 show a number of companies paying zero tax, or less than the 30% tax rate. The individual companies are best placed to defend their tax payments; however there are numerous legitimate reasons why particular companies can be paying low rates of tax.

- A business makes a loss. In each of the last 10 years, between 20% and 30% of the ASX top 500 companies made a loss.[28]
- A company carrying forward a tax loss from previous years to offset current year tax payments. These companies are not avoiding tax at all: in in fact they are effectively paying a *higher* rate of tax because they can't obtain the full value of tax losses for several years after they make a loss.
- Companies receiving foreign income, particularly where the income has been subject to tax overseas.
- Businesses making use of tax incentives, such as the R&D tax concession and accelerated depreciation.
- Some entities pass through tax liabilities to their owners, rather than paying tax themselves, for example, some trusts operating as collective investment vehicles. Looking at the tax paid by the trust, or related entities, can give an erroneous impression of substantial tax avoidance occurring.

Other reasons for companies paying what might appear to be low rates of tax have been highlighted by the ATO[29] and other submissions to this Inquiry.[30]

All these reasons for low rates of tax payment have been explicitly put into the tax law by Parliament.[31] Criticisms of the use of tax provisions are indirectly criticisms of the Governments and Parliaments that put these provisions into place.

Conversely, if there are problems with a company making use of a tax provision, then it is open to Parliamentarians to bring forward legislation to change these provisions, rather than complain about companies making use of provisions that were deliberately put in place.

The future of tax avoidance

The data presented in this submission shows corporate tax avoidance is not a significant issue in Australia currently.

However, there is potential for tax avoidance to grow in coming decades, for reasons including:

- More economic activity may move to low tax locations: activities that have no physical location at all (such as the sale of software), or services that can be delivered remotely (such as legal, accounting, design, administration and some medical services). Online services such as Airtasker are facilitating this change.[32]
- Similarly, intangible assets (such as patents, trademarks and goodwill) can be located in low tax jurisdictions and licenced out to Australian operations at high prices. Because these intangibles are usually unique, it is very hard to argue that these licencing prices are excessive.[33]
- Consumers will be more easily able to bypass taxes imposed on Australian businesses by buying directly from overseas. Examples include digital downloads, and

Australian consumers buying insurance direct from offshore insurers. The government has recently imposed GST on these type of transactions, but it is hard to see that any company tax could be imposed.
- Cryptocurrencies will make it easier to conduct transactions that are, at least in theory, completely undetectable and impossible to tax.
- Businesses that are more mobile internationally might just move their corporate residency offshore. This has already occurred in the US, which has a corporate tax rate of 35%, plus state income taxes. A number of businesses have moved offshore from the US in so-called ‘corporate inversions’, potentially reducing US tax payments by $US40 billion over a decade.[34]

These issues mean the corporate tax base may decline over time with little or nothing governments can do about it. Attempting to stop this base erosion is a losing battle, and the erosion will only be encouraged by Australia’s uncompetitively high tax rates. Our high tax rates will just penalise the local companies that can’t implement tax avoidance (or evasion) strategies.

The Centre for Independent Studies (CIS)

The Centre for Independent Studies is the leading independent public policy think tank in Australasia. Founded in 1976, our work is informed by a commitment to the principles underpinning a free and open society:

- individual liberty and choice, including freedom of association, religion, speech and the right to property
- an economy based on free markets
- democratic government under the rule of law
- an autonomous and free civil society

The CIS works on aspects of social and economic policy affecting both Australia and New Zealand. The Centre prides itself on being independent and non-partisan in its funding and research. It is funded by donations from individuals, companies, and charitable trusts, as well as by subscriptions and book sales.

'Independent' in our name means:

- we are politically non-partisan
- our research is not directed by our supporters
- we are financially independent of government

[1] Wayne Swan (2016) "Liberal's Unfunded Corporate Tax Cut Undermined By ATO Data Showing Widespread

Tax Minimisation & Evasion", Media Release, 9 December.
The Australia Institute (2016) "Company tax cuts: Report shows lack of evidence of 'Growth Dividend'", 29 March.
Ross McClure, Roman Lanis and Brett Govendir (2016) *Analysis of Tax Avoidance Strategies of Top Foreign Multinationals Operating in Australia: An Expose*, University of Technology Sydney.
[2] See http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporatetax45th/Terms_of_Reference
[3] Warwick Smith (2015) *FactCheck: is Australia's corporate tax rate not competitive with the rest of the region? — Review*, The Conversation, 10 February; Kevin Davis (2012) *Australia's company tax 'burden' is just a myth*, The Conversation, 31 October; John Daley & Brendan Coates (2016) "The full story on company tax cuts and your hip pocket", *The Conversation*, 18 May; David Richardson (2016) *Company Tax cuts: an Australian Gift to US Internal Revenue Service*, The Australia Institute Briefing Paper, May; and David Richardson (2015) *Cutting the company tax rate: Why would you?* The Australia Institute Discussion Paper, December
[4] Michael Potter (2016) *Fix it or Fail: why we must cut company tax now*, CIS Research Report 20, October, Box 1
[5] Michael Potter (2016) *Fix it or Fail: why we must cut company tax now*, CIS Research Report 20, October, Box 1.
[6] Michael Potter (2016) *Fix it or Fail: why we must cut company tax now*, CIS Research Report 20, October, Page 7.
[7] Michael Potter (2016) *The case against tax increases in Australia: The growing burden*, CIS Research Report 15, Box 2.
[8] Michael Potter (2016) *Fix it or Fail: why we must cut company tax now*, CIS Research Report 20, October, Figure 5
[9] Michael Potter (2016) *Fix it or Fail: why we must cut company tax now*, CIS Research Report 20, October, page 7.
[10] See Endnote 5.
[11] Michael Potter (2016) *Fix it or Fail: why we must cut company tax now*, CIS Research Report 20, October, Figure 6.
[12] Source: OECD Revenue Statistics.
[13] Technically gross operating surplus plus gross mixed income.
[14] OECD Revenue Statistics and OECD.Stat.
[15] Source: Figure 2 of PwC & Business Roundtable (2011) *Global Effective Tax Rates*, April 14. The average in the Business Roundtable paper excludes the United States; the average in this paper includes the US.
[16] Source: http://www.pwc.com/gx/en/services/tax/paying-taxes-2016/comparative-modeller.html
The World Bank report was written in conjunction with PriceWaterhouse Coopers.
[17] Jack Mintz, Philip Bazel & Duanjie Chen (2016) *Growing the Australian economy with a competitive company tax*, Minerals Council of Australia Policy paper, March.
[18] Michael Potter (2016) *Fix it or Fail: why we must cut company tax now*, CIS Research Report 20, October, Figure 7.
[19] Australian Taxation Office (2015) *Submission to Senate Inquiry into Corporate Tax Avoidance*
[20] Commissioner of Taxation (2016) *Annual Report 2015–16*, page 43.
[21] Commissioner of Taxation (2016) *Annual Report 2015–16*, Table 2.8.
[22] Joanna Mather (2017) "The ATO just accused you of being a bigger tax problem than Apple", Australian Financial Review, 16 March.
[23] Michael Potter (2016) *Fix it or Fail: why we must cut company tax now*, CIS Research Report 20, October, Figure 11; ATO (2016) *Corporate tax transparency: report of entity tax information for 2014–15*.
[24] Source: see endnote 23.
[25] ATO (2016) *Corporate tax transparency: report of entity tax information for 2014–15* and ATO (2015) *Corporate tax transparency: report of entity tax information for 2013–14*.
[26] See for example, Wayne Swan in an interview on ABC "there is no case for a company tax rate [cut] when so many companies aren't paying the nominal rate or anywhere near the nominal rate." Radio National Breakfast, 5 April 2016, available from: http://www.abc.net.au/radionational/programs/breakfast/wayne-swan-talks-tax-evasion/7299242
Lenore Taylor (2016) "Pesky facts are spoiling Scott Morrison's economic story", *The Guardian*, 15 April.
[27] See for example Oliver Lang, Karl-Heinz Nöhrbaß, and Konrad Stahl (1997) "On Income Tax Avoidance: The Case of Germany" *Journal of Public Economics* 66(2), pp327–47 and Martin Feldstein (1999) "Tax Avoidance and the Deadweight Loss of the Income Tax" *Review of Economics and Statistics* 81(4), pp674–80. See also the

discussion and citations in Chris Murphy (2016) *The effects on consumer welfare of a corporate tax cut*, ANU Working papers in Trade and Development 2016/10.

[28] ATO *Corporate tax transparency report for 2013–14, contextual background*.

[29] As above.

[30] See for example Corporate Tax Association (2015) *Inquiry into Corporate Tax Avoidance and Minimisation, submission to Senate Standing Committee on Economics*, February.

[31] For example, both major parties support the R&D tax concession, with some trimming. The ALP's support is indicated in websites including: http://www.alp.org.au/startupyear and the Coalition's is indicated in government websites including: https://www.business.gov.au/assistance/research-and-development-tax-incentive. Both parties supported a reduction in the incentive by 1.5% in the 2016 election campaign, see: http://www.100positivepolicies.org.au/labors_budget_repair_strategy

[32] Australian Government (2015) *Re:think*, page 81 and KPMG (2016) *Tax 2025*, August

[33] Kimberly Clausing, Edward Kleinbard & Thornton Matheson (2016) *US Corporate Income Tax Reform and its Spillovers*. International Monetary Fund Working Paper No. 16/127.

[34] Jeffrey Zients, Seth Hanlon (2016) "The Corporate Inversions Tax Loophole: What You Need to Know", Whitehouse blog, 8 April.