

# Chapter 2

## Overview of Australia's corporate tax system

2.1 This chapter provides an overview of Australia's corporate tax system and its importance as a source of public revenue. In particular, this chapter:

- provides an introduction to Australia's corporate tax system;
- considers the international context; and
- explores the broad impacts associated with tax avoidance and aggressive minimisation.

### Introduction to Australia's corporate income tax system

2.2 Australia's taxation system is extremely complex and issues relating to corporate tax are no different. As such, the information presented in this section provides a brief overview of how the corporate income tax system operates—noting there are many highly technical rules and interpretations that affect businesses and investment decisions, and the amount of corporate income tax paid.

2.3 While corporations pay a variety of taxes and levies (including payroll tax, GST and royalties) to different levels of government, the potential for tax avoidance and aggressive minimisation appears to be greatest in the area of corporate income tax. That said, there are also competition concerns when corporations may have different costs structures because of the taxes levied on them by virtue of operating from other jurisdictions. These issues are explored in chapter 5.

### *Corporate income tax is levied on assessable income*

2.4 Australian corporations that are considered permanent establishments are required to pay corporate income tax on assessable income. The general rate of taxation is 30 per cent but there are some variations for a small number of specific company types. Assessable income is defined as total revenue less allowable deductions that are associated with the costs of doing business.

2.5 Corporations are entitled to deduct various expenses relating to their business operations. Allowable deductions include:

- costs incurred in supplying goods and services, including employee costs;
- interest payments on borrowed money;
- depreciation and amortisation of capital goods; and
- research and development expenses.

2.6 Australia has a broad-based company income tax regime which seeks to tax assessable income on a territorial basis—that is, in the jurisdiction where it is sourced. If assessable income is derived from activities within Australia, then that income is taxed according to the Australian company tax regime.<sup>1</sup>

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1 Treasury, *Risks to Australia's Corporate Tax Base*, Scoping Paper, July 2013, p. 11.

2.7 Where assessable income is derived from activities outside Australia, that income is generally exempt from corporate income tax provided that the income was 'actively' earned.<sup>2</sup> In certain circumstances, however, corporations may be required to pay 'top-up' tax to Australia on repatriated earnings as required by Controlled Foreign Company rules. For example, BHP Billiton has paid 'top-up' tax to Australia on profits repatriated from its Singapore marketing hub.<sup>3</sup>

*Certain types of corporations are exempt from paying income tax*

2.8 While most corporations undertaking business activities are required to pay corporate income tax, certain types of corporate entities are not liable.

2.9 Partnerships and trusts are not required to pay corporate tax provided their assessable income is distributed to unit holders. Unit holders are then required to pay either corporate tax (in the case of a company) or personal income tax (in the case of individuals) on distributed income on a flow-through basis.

2.10 Property trusts, such as Real Estate Investment Trusts (REITs), do not pay corporate income tax on passive rental income but distribute this to investors who pay tax at their own individual tax rate.<sup>4</sup> In Australia, stapled securities are used to split the passive and active income earning activities of property investments. Active income from trading activities, such as funds management and property development, are subject to corporate income tax.<sup>5</sup>

2.11 Other types of incorporated entities are also exempt from paying income tax, such as certain non-profit organisations and charities.

### ***Breakdown of corporate tax in Australia***

*Large companies pay the majority of corporate income tax*

2.12 Over 850,000 companies lodged a tax return in 2012–13 and paid \$66.9 billion in company income tax.<sup>6</sup> This represented about 19 per cent of total federal tax receipts.<sup>7</sup>

2.13 Corporate tax revenue is highly concentrated with the majority of corporate tax paid by only a relatively small number of companies. For example, large companies with turnover of greater than \$250 million account for over 60 per cent of

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2 By contrast, individual and 'passive' business income is taxed on a worldwide basis and, as such, is levied on total assessable income regardless of the jurisdiction in which it is sourced. The Board of Taxation, *Review of Debt and Equity Tax Rules: Discussion Paper*, March 2014.

3 *Answer to Question on Notice No. 14*, p. 1.

4 Property Council of Australia, *Submission 18*, p. 5.

5 Property Council of Australia, *Submission 18*, p. 5.

6 ATO, *Submission 48*, pp. 6–7.

7 Australian Government, *Re:think—Tax Discussion Paper*, March 2015, p. 76.

net corporate income tax but represent less than 0.2 per cent of the total number of corporate entities that lodged a tax return.<sup>8</sup>

**Table 2.1: Corporate tax characteristics by entity size, 2012–13<sup>9</sup>**

	<b>Annual Turnover</b>	<b>Number</b>	<b>Proportion of corporations</b>	<b>Net tax (\$b)</b>	<b>Proportion of net tax</b>
Large	Greater than \$250 million	1,091	0.1	38.7	61.1
Medium	\$10 million to \$250 million	16,031	1.9	11.1	17.5
Small	\$2 million to \$10 million	56,136	6.5	6.2	9.8
Micro	\$1 to \$2 million	670,564	77.6	7.2	11.4
Loss/Nil	Less than \$1	120,384	13.9	0.1	0.2
<b>Total</b>			<b>100</b>	<b>63.3<sup>10</sup></b>	<b>100</b>

2.14 The ATO noted that 69 higher consequence (or key) taxpayers, which typically have a turnover of more than \$5 billion annually, represent 42 per cent of the entire corporate tax base.<sup>11</sup>

2.15 In terms of industry contributions, the financial services and mining industries accounted for over half of all corporate tax revenue in 2012–13.<sup>12</sup> However, given the cyclical nature of the mining industry and recent falls in commodity prices, it is unlikely that this sector will continue to contribute income tax revenue to the same level in the short term.

2.16 Losses can also have a significant effect on income tax revenue as prior year losses can be offset against current year income. In 2012–13, 148,738 companies used \$18.1 billion in prior year tax losses to offset income tax liabilities and the balance of carried forward losses for all companies was \$264.3 billion.<sup>13</sup>

8 ATO, *Submission 48*, pp. 5–6.

9 ATO, *Submission 48*, p. 5.

10 According to the ATO, net income tax payable in 2012–13 was \$63.3 billion whereas company income tax collections were \$66.9 billion. Tax payable represents the tax obligation for the year (calculated after the tax return is completed) whereas tax collected represents the tax collected during the year (PAYG instalments, wash-up payments and refunds).

11 *Committee Hansard*, 8 April 2015, p. 19.

12 ATO, *Submission 48*, p. 7.

13 ATO, *Submission 48*, p. 10.

*Private companies are also important contributors*

2.17 Private companies contributed \$22 billion, or about a third, of the total corporate tax paid in 2012–13. Almost 70 per cent of the tax paid by this group was from private companies with turnover greater than \$2 million.<sup>14</sup>

2.18 There are 147,000 private companies associated with 220,000 private groups linked to 119,000 wealthy individuals, defined as resident individuals who, together with their business associates, control more than \$5 million in net wealth.<sup>15</sup>

2.19 Wealthy individuals and their private groups often have complex arrangements and utilise flow-through entities, such as trusts and partnerships in addition to companies.<sup>16</sup>

*Corporate income tax is an important contributor to Commonwealth revenue*

2.20 Corporate income tax is an important part of Australia's tax base and is the second largest contributor to tax revenue after personal income tax.

2.21 Australia's company tax revenue as a proportion of GDP at 5.2 per cent is higher than the OECD average of 2.9 per cent.<sup>17</sup> This relatively high proportion reflects a number of factors including:

- Levels of incorporation differ across countries, and the classification of income companies may differ.
- Levels of corporate sector profitability differ across countries.
- Incentives for domestically-owned companies to pay tax in Australia in order to pay fully franked dividends under the imputation system.
- Australia's company income tax regime is relatively broad-based, with limited concessional write-off arrangements compared to many OECD countries.<sup>18</sup>

2.22 In addition, Australia does not levy social security taxes, which are a large source of direct taxation revenue for a significant number of OECD countries.<sup>19</sup>

*Corporate income tax and personal income tax are inter-related*

2.23 Australia's system of dividend imputation effectively links the corporate and personal income tax systems, whereby taxes paid by companies are distributed to shareholders via franked dividends. Franked dividends have tax credits attached that allow Australian shareholders to offset their income tax. By comparison, trust income

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14 ATO, *Submission 48*, p. 12.

15 ATO, *Submission 48*, p. 12.

16 ATO, *Submission 48*, p. 12.

17 Australian Government, *Re:think—Tax Discussion Paper*, March 2015, p. 75.

18 Australia's Future Tax System Review Panel, *Australia's Future Tax System*, 2 May 2010, p. 159.

19 Treasury, *Pocket guide to the Australian taxation system 2012–13*, 2013, p. 3.

distributed on a flow-through basis is not franked and does not have tax credits attached.

2.24 Dividend imputation systems are rare internationally with most countries undertaking some form of 'double taxation', whereby corporate income taxes are paid on profits and personal income taxes are paid on dividends (with some countries levying lower personal tax rates on dividends compared to earned income). Australia, New Zealand, Chile and Mexico are the only OECD countries to operate a dividend imputation system.<sup>20</sup>

2.25 The majority of Commonwealth revenue in Australia is sourced from personal and corporate income taxes, collectively representing over 70 per cent of total revenue in 2012–13.<sup>21</sup> As a result, Commonwealth revenue is highly susceptible to base erosion if the integrity of the income tax regime is compromised.

#### *International comparisons of corporate income tax*

2.26 Australia's statutory corporate tax rate of 30 per cent is roughly equal to the average corporate tax rate of the nations with the 10 largest economies.<sup>22</sup> However, it is higher than both the OECD average (25.3 per cent) and other small to medium OECD countries (23.9 per cent).<sup>23</sup> Based on corporate tax rates alone, Australia is at a comparative disadvantage in attracting foreign investment.

2.27 This disadvantage is exacerbated where countries choose competitive corporate income tax policies to attract economic activity. For example, some large multinational companies have established entities in Singapore, Hong Kong or Ireland where statutory corporate income tax rates are 17, 16.5 and 12.5 per cent respectively.

2.28 Some countries have preferential agreements with certain corporate entities to reduce the effective rate of tax paid. The committee heard that Singapore has had programs in place since 1967 to encourage multinational corporations to set up and operate activity hubs.<sup>24</sup> As such, many large corporations have negotiated effective tax rates much lower than the statutory rate. For example, BHP Billiton effectively pays no income tax on profits from its Singapore marketing operations.<sup>25</sup>

2.29 Submissions and previous reviews have highlighted that proposed changes to reduce the rate of corporate income tax may not substantially alter the tax

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20 Australian Government, *Re:think—Tax Discussion Paper*, March 2015, p 85.

21 Australian Government, *Re:think—Tax Discussion Paper*, March 2015, p. 21.

22 Australian Government, *Re:think—Tax Discussion Paper*, March 2015, p. 75.

23 OECD, *OECD Tax Database*, <http://www.oecd.org/tax/tax-policy/tax-database.htm> (accessed 19 March 2015). Data presented is for 2014 and reflects combined state and federal corporate income tax rates (where levied).

24 Mr Grant Wardell-Johnson, KPMG, *Committee Hansard*, 9 April 2015, p. 9.

25 BHP Billiton, *Answer to Question on Notice No. 14*, 24 April 2015, p. 1.

competitiveness of Australia relative to other countries where multinational corporations may choose to base their operations.<sup>26</sup>

### **International aspects of corporate taxation**

2.30 Developments in technology and the increasing importance of trade in the operations of multinational companies have resulted in an international taxation system that is outdated and provides opportunities for multinational corporations to exploit loopholes and discrepancies between jurisdictions.

2.31 The ATO notes that the rapid pace of globalisation has seen the Australian economy become increasingly interconnected with the global economy across all markets. This has arisen from improvements in technology and reduced barriers to international trade, and the adoption of global value chain approaches to operations, particularly within multinational corporations.<sup>27</sup>

2.32 Tax treaties and other international tax agreements were intended to facilitate international investment and avoid double taxation. While they have been effective in achieving their intended purpose, they also provide organisations with mechanisms to exploit 'double non-taxation' opportunities.

### ***Domestic treatment of foreign source income***

2.33 As noted earlier, the tax treatment of foreign source income depends on the jurisdiction in which it is sourced and whether it is captured by Controlled Foreign Company (CFC) rules.

2.34 These arrangements are generally covered by treaties (bi- and multi- lateral) and avoid 'double taxation' of income in both jurisdictions. This is consistent with the notion of taxing income on a territorial basis. Such arrangements generally only apply to income that is 'actively' earned, not passive income (such as interest or rent).

2.35 Income from subsidiaries resident in jurisdictions that have similar tax systems to Australia, known as 'listed' jurisdictions, is generally exempt in corporate income tax considerations.

2.36 Income from subsidiaries resident in other jurisdictions, known as 'unlisted' jurisdictions, is generally liable for corporate income tax in Australia but may be given a tax credit for any tax already paid in a foreign jurisdiction.

2.37 Under Australia's Controlled Foreign Company (CFC) rules, domestic companies that have a controlling interest in a foreign company are liable to pay the Australian corporate tax rate on income from that company.

2.38 For example, even though BHP Billiton Marketing (Singapore Branch) pays almost no corporate tax in Singapore, its Australian parent company, BHP Billiton Australia, owns 58 per cent of the company and has been required to pay

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26 See, for example, the *Review of Australia's Future Tax System*, p. 155; and The Australia Institute, *Submission 62*, pp. 4–6.

27 *Submission 48*, p. 10.

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A\$945 million in 'top-up tax' to the ATO on the profits of BHP Billiton Marketing (Singapore Branch) for the period 2006 to 2014.<sup>28</sup>

### ***Treatment of income sourced in Australia by foreign-based organisations***

2.39 Where tax treaties exist between jurisdictions, companies can effectively choose the jurisdiction where they pay corporate income tax by creating permanent establishments in these jurisdictions. As Australia has a relatively high corporate income tax rate compared to other jurisdictions in the Asian region, it is not surprising that corporations will structure their operations so that they are based, and pay corporate tax, in jurisdictions where after tax profits are maximised.

2.40 Withholding tax is applied to unfranked dividends, interest payments and royalties for payments made to non-residents or foreign branches of Australian residents. The rate of withholding tax depends on the type of payment and the terms of any tax treaty that may be in place.<sup>29</sup>

2.41 In the context of the digital economy, tax integrity issues arise from the way in which income is recorded for corporate tax purposes where a foreign company provides 'digital services' (payment and provision) from a foreign jurisdiction. For example, the provision of advertising services over the internet where the service is purchased and consumed in Australia from a company based in a lower tax jurisdiction, such as Singapore, as in the case of Google and Microsoft. These structures often avoid permanent establishment status and enable multinational corporations to attribute revenue from Australian sources to foreign jurisdictions. As a result, this Australian sourced income may not currently be liable for Australian company income tax.

### ***International related party dealings (IRPDs)***

2.42 International related party dealings (IRPDs) represent the flow of cross border transactions between related entities (in the same corporate group).<sup>30</sup> They are a necessary and legitimate part of a multinational entity's global operations.<sup>31</sup>

2.43 IRPDs arise from the transfer of goods and services between jurisdictions, particularly where one jurisdiction serves as a regional base or is a centralised location for specific activities.

2.44 According to the ATO, the total value of IRPDs between Australia and all countries in 2012–13 was \$326.7 billion (excluding derivatives, debt factoring and securitisation) which accounts for over half of the \$599.6 billion in total trade.<sup>32</sup>

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28 BHP Billiton, *Answer to Question on Notice No. 14*, 24 April 2015, p. 1.

29 Australian Government, *Re:think—Tax Discussion Paper*, March 2015, p. 92.

30 ATO, *Submission 48*, p. 10.

31 ATO, *Answer to Question on Notice No. 7*, p. 3.

32 *Submission 48*, p. 10.

2.45 Singapore had by far the largest IRPD flows with over \$100 billion exchanged in 2012–13, reflecting the importance of this jurisdiction as a hub for regional activities.<sup>33</sup>

2.46 While many foreign based multinational corporates, such as Google and Apple, have chosen to use Singapore as a regional base for operations in the Asia-Pacific, some large Australian mining multinationals, such as BHP Billiton and Rio Tinto, have strategically established operations in Singapore to act as a base for marketing their products.

2.47 Other Australian companies source their raw materials or final products from Singapore. For example, Australia imports the majority of its transport fuels from Singapore as it is the regional hub for the refining, trading and distribution of these products.

2.48 The value of IRPDs is highly concentrated within the largest 30 corporate entities which account for approximately 50 per cent of total IRPDs.<sup>34</sup>

2.49 Related party flows broadly reflect actual trade flows but there are some differences. In 2012–13, Australia's top five trading partners were China, Japan, the United States, Republic of Korea and Singapore, while the top five related party flows by country were Singapore, United States, Japan, Great Britain and Switzerland. The ATO considers the differences are due to the way in which trade flows are captured and may reflect the use of offshore hubs by multinational enterprises. For example, Singapore and Switzerland are commonly used as financing hubs for Asia and Europe respectively.<sup>35</sup>

2.50 Information about trade flows and IRPDs is useful to understand the operations of multinational corporations and to identify aggressive tax planning activities. However, as IRPDs are generally subject to internationally agreed 'arm's length' transfer pricing rules, the dollar value of related party transactions does not represent the amount of profits that are being artificially shifted from one jurisdiction to another.<sup>36</sup>

### **Tax avoidance and aggressive minimisation have broad impacts**

2.51 Aggressive tax minimisation and avoidance can have a number of direct and indirect consequences for the broader economy and social fabric. Some submissions reflected growing concerns that tax avoidance causes serious harm, often to the most vulnerable groups in society, as unrealised corporate tax revenue denies governments revenue for essential public services, such as healthcare, education, effective law enforcement, aged care and roads.<sup>37</sup> In essence, failure to address base erosion and tax

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33 ATO, *Answer to Question on Notice No. 7*, p. 11.

34 ATO, *Submission 48*, p. 10.

35 *Submission 48*, p. 11.

36 ATO, *Answer to Question on Notice No. 7*, p. 3.

37 Uniting Church of Australia, Synod of Victoria and Tasmania, *Submission 74*, p. 3 and Action Aid Australia, *Submission 67*, p. [2].

leakage means that the tax burden eventually falls more heavily on other taxpayers and/or government does not provide the same level of services it would otherwise be able to provide.

2.52 Also, if left unaddressed, tax avoidance reduces the efficiency, fairness and sustainability of the tax system. This leads to unfair competitive disadvantages for businesses that do the right thing and, ultimately, distorts investment decisions.<sup>38</sup>

2.53 Further, tax avoidance can undermine the integrity of the tax system and skew social and economic interactions by favouring those who can best afford to develop and implement the most effective tax strategy, usually large corporations and wealthy individuals. This has the potential to create widespread distrust and a reluctance to comply when others are not.<sup>39</sup> The Uniting Church of Australia, Synod of Victoria and Tasmania, noted the importance of trust and legitimacy in supporting the tax system:

...it needs to be acknowledged that where a corporation is able to engage in tax avoidance without any counter-action being taken, it will encourage others to also engage in the same behaviour resulting in further loss of tax revenue.<sup>40</sup>

2.54 Maintaining public confidence in Australia's tax system is vital to ensure voluntary compliance and this confidence can best be fostered by preserving the integrity of the system.<sup>41</sup>

*But so do legitimate tax planning activities*

2.55 As discussed in chapter 1, the distinction between tax minimisation and tax avoidance is usually subtle, technical and largely open to opinion. Disputes between companies and the tax officials may arise when certain tax planning arrangements are considered to be 'aggressive' or not in the 'spirit of the law'. Tax minimisation only becomes avoidance when it is done for the sole or dominant purpose—not just an incidental purpose—of paying less tax.<sup>42</sup>

2.56 Indeed, the Australian tax system actively encourages minimisation by providing for deductions across a range of activities, and for various social and economic goals. For example, research and development tax concessions are intended to boost competitiveness and improve productivity across the Australian economy. This sentiment was conveyed by the Institute of Public Affairs:

There is nothing wrong with an individual or company, structuring their affairs to pay the minimum legal amount of tax. In many cases the system

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38 Treasury, *Addressing profit shifting through the artificial loading of debt in Australia*, Proposals Paper, 14 May 2013, p. 1.

39 Treasury, *Addressing profit shifting through the artificial loading of debt in Australia*, Proposals Paper, 14 May 2013, p. 1.

40 *Submission 74*, p. 3.

41 Minerals Council of Australia, *Submission 54*, p. 2.

42 The committee notes that this definition may change as a result of the proposed introduction of the Multinational Anti-Avoidance Law.

has been deliberately designed to encourage that, for various social and economic goals. The complexity of the existing tax system reflects policy decisions. It is not accidental.<sup>43</sup>

2.57 Further, company executives and board members have a duty under corporations law to act in the best interests of a company's owners and maximise returns. As such, the concern over corporate and multinational tax avoidance, base erosion and profit shifting should perhaps better be viewed in light of the continuing exploitation of tax-effective minimisation opportunities that the law allows.

2.58 The important question for parliament and the broader community which they represent is not which instances of tax minimisation are unlawful but rather which ones are unacceptable. Unacceptable tax minimisation opportunities will require legislative amendment to remove their attraction as appeals to a collective corporate conscience are unlikely to change behaviour when companies insist that what they are doing is legal and in the interests of their shareholders.

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43 *Submission 42*, p. 4.