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Company Income Tax & Tax Avoidance

A DISCUSSION PAPER

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Executive Summary

Over the past year an enormity of corporate tax avoidance within Australia has made headlines. As with other nations, the global reach of multinational organisations has provided mechanisms for firms to easily avoid the payment of tax. The inability to impose taxation on the largest recipients of wealth within the nation directly impacts government funding. It also creates a competitive imbalance toward multinationals that disadvantages small and local business.

This paper discusses the mechanisms of tax avoidance. By doing so, the impossibility of preventing the abuse without a radical rethinking of corporate tax is evidenced. The concluding sections discuss one particular taxation concept that appears to prevent existing forms of tax avoidance with potentially beneficial economic side-effects.

The conclusion of this discussion suggests a radical departure over corporate tax and tax deductions could quite easily prevent profit shifting and corporate tax avoidance while encouraging local business development without the use of tariffs. This paper has been written based on Australian revelations as to the extent of corporate tax avoidance within its economy but the proposals are transferrable to other economies.

Corporate Tax Avoidance – The Problem

Defining Big Business in Australia

Before reviewing available data as to the size of the corporate tax avoidance problem in Australia, it's important to review some of the terms used in government documentation. It should be of little surprise of how important small and medium sized enterprise is to the economy as a whole.

The Australia Government uses definition of "small", "medium" and "big" business. It's important to highlight that these terms are non-specific. No common definition is agreed internationally and agencies within the Australian government use different factors for the definition.

For the purpose of discussing tax avoidance, the definitions of business size from the Australia Tax Office and the Bureau of Statistics are most commonly referenced.

	Bureau of Statistics (employment)	Australian Tax Office (annual turnover)
Small Business	Fewer than 20 employees	Less than $10m
Medium Business	Between 20 & 200 employees	Between $10m & $250m
Big Business	More than 200 employees	Greater than $250m

Regardless of the fuzzy categorisations for Australian business, the importance of small to medium sized business within the economy cannot be overstated. Profile data of the sector demonstrates that:

- Small business accounts for almost half of "non-financial" employment in the Private Sector
- Small & Medium sized business accounts for 71% of private sector.
- Mid sector market makes up 1.4% of all Australian business but contributes $34% of business revenue.
- Small & Medium Enterprises comprise of 99% of all business. 40% are engaged in some form of innovation.
- Fewer than 40% of small business hold debt
- More 97% of Small & Medium sized business is 100% Australian owned (compared to 74% of big business in Australia).
- 47% of all goods exports are from small business
- Small businesses exported goods to the value of $1.2 billion in 2009–10, representing 0.6 per cent of the total value of goods exported (up from 0.5 per cent in 2008–09).

Within the large sectors of "Agriculture, forestry and fishing" 96% of GDP contribution is from small and medium sized business, 62% of the services sector, 79% of construction, 71% of "Professional, scientific and technical services", and 76% of the Accommodation and Food sector. Even with the inclusion of statistics from the massive mining and manufacturing sectors, small and medium sized business provides 57% of GDP.

Australian small and/or medium businesses or organisations were the main suppliers of goods and services for almost two-thirds of all businesses (63 per cent).

In terms of innovation, employment, local ownership and revenue generation, small to medium sized business dominate the beneficial aspects of economy in Australia. The issue of tax avoidance is primarily a problem made possible by transnational ownership structures associated with big business. Regardless of ethical concerns over tax avoidance, the impact of unequal competition

between multinational firms avoiding taxation, and their small to mid-sized Australian competitors should be of major concern.

Australian Taxation - Sources

47% of taxation in Australia is the result of individual income tax. GST (also paid for by salary and wage earners) accounts for a further 14% of government income. Comparatively, **company tax provides only 22.6%** of government revenue. Considering the dominance of the same multinational firms occupying the shop frontage and skylines of every city and town in the nation, the existing business contribution toward overall tax appears unexpectedly low.

During 2009-2010, small to medium sized business contributed 41.8% of company tax. In that period, 927 firms were categorised as “big business” (with an annual turnover of more than $250m), and contributed 58.2% of company tax. Although the big business contribution toward taxation revenue appears considerable, further observations suggest the wealth extracted from the economy by these corporations vastly dwarfs any taxation paid.

Deputy Commissioner of Taxation, Jim Killaly, stated in 2010 that **40 percent of big business paid no income tax** in the years between 2005 and 2008.

The Australian Tax Office also stated that during the financial year of 2008/09, **59.8% of all business paid no income tax**. The mining industry had the highest percentage of companies (73.2%) paying no tax. The most recently released Australian Tax Office data shows the trends of large scale tax avoidance to be unaffected after a year of embarrassing revelations and scrutiny. Data released December 2015 showed that of the biggest 1,539 firms, 38% paid no tax while a further 37% paid an effective tax rate between 1%-3%

Some of the most stunning examples of recent tax avoidance have been:

- Sydney Airport was able to earn $8 billion in revenue from 2002 – 2012 and pay no corporate tax during that entire period.
- Two of Australia’s largest firms, James Hardy and Westfield payed no tax last year.
- Yokohama Tyres (Australia) earned $121 million (2013-2014), declared a taxable income of $747,000 and paid no tax.
- Apple (Australia) took $26.7 billion from the Australian economy between 2002 and 2013 and paid $193 million in tax (or 0.7% of turnover).
- Apple (Australia) took $8 billion in local revenue over the last financial year. It declared only $208 million as its before-tax profit (declaring $7.8 billion in costs). The company paid only $86 million in tax.
- Google (Australia) receives revenues from the Australian economy in excess of a billion dollars a year and pays (at maximum) 0.5% of the income stream in tax.
- 57% of ASX 200 companies have subsidiaries in tax havens while a third of that group paid less than 10% tax.
- Chevron Australia paid its US parent company $1.8 billion in 2014 in debt servicing charges of which the US firm paid only $248 in tax.
- Other large corporations that did not pay tax (2013-2014) include Qantas, Virgin Australia, General Motors, Vodafone, ExxonMobil, William Hill, Warner Bros Entertainment, Lend Lease and Ten Network Holdings.

The figures show that tax avoidance is endemic amongst businesses operating within Australia. Vast streams of lost taxation revenue being denied to the public purse.

The Australian Tax Office recently estimated that **100 billion dollars** is annually transferred from the Australian economy to international tax havens / hubs for the purpose of avoiding tax in Australia. The figure represented is comparable to the entire Federal expenditure on Health, Education and Infrastructure.

Multinational Tax Avoidance Mechanisms

Avoiding tax is legal and very simple for multinational firms to achieve. To understand the impossibility of preventing tax avoidance within our current structures, it's important to reflect on some of the most common methods for shifting surplus' into costs.

- **Supply of goods & Services under License**
  Foreign elements of a multinational firm can require ongoing license costs for each unit of a product sold or for "franchise" operating. Separate agreements between the Australian firm and parent company establish the transfer of funds from the Australian firm as a cost of leveraging a "brand".
- **Foreign controlled unit cost of Goods and Services**
  Foreign elements of a multinational firm can maximise the unit cost for the Australian firm "buying" the products it wishes to sell locally. A pair of logo branded shoes that may cost a few cents for a parent firm to produce and transport to Australia but the local arm of the firm can then be charged a hundred times the actual cost of purchasing or suppling the product.
- **Debt Repayment Conditions**
  The establishment of company debt to external elements of a multinational allows servicing payments to be made internationally as business costs. Local Australian businesses can operate under legal requirements of transferring large amounts of funds offshore as operating costs according to the rate of interest and repayment conditions established with the debt held.

The alarming incidence of international profit-shifting should be of great concern as every dollar shifted out of the economy, without being taxed, represents income that is unlikely to ever return.

As a result of the mechanisms of tax avoidance employed, some conclusions can be drawn.

- ❖ It would appear impossible for governments to ever hope to regulate the internal charging between parts of a multinational firm.
- ❖ Multinational firms will continue to transfer funds between offshoot organisations as a means of maximising shareholder returns.
- ❖ As long as corporate taxation is based on declared profits a glaring loophole allows for the accounting of costs and profits to directly determine the tax to be paid. Therefore, tax is based on creative accounting instead of real, disposable corporate income.

To date, the most common international response to the failure of applying taxation to multinational corporations has been a suggestion that "loopholes" can be closed and "transparency" will force big business to adopt comparable taxation practices to those of small and medium sized business (or even to low income earners). The current mechanisms of tax avoidance are legal, transparent and certainly not loopholes. The ability for firms to effectively name their own level of tax is due to the ability of corporate entities to use internal cross charging systems to construct their own accounting provisions, which determine where profits are globally accrued.

Existing Company Tax Complexity & Compliance

"…most expenses you incur in running your business are tax deductible"

The Australian Tax Office website states "most expenses you incur in running your business are tax deductible". The simple statement forms the basis of what company tax represents. The idea is simply, the profits of a business are dependent on deducting the costs for running a business from the overall income of the business. The specific regulation surrounding the specifics of declaring income and deductable costs is large and at times convoluted.

The current level of big-business tax avoidance in Australia demonstrates the system of accounting expenses (and therefore profits) is open to widespread abuse.

A vast list of categories can be referenced to deduct expenses from an income stream. These include (*but are not limited to*);

> Electricity, fuel, Franchise fees, Interest on business loans, depreciation, stock and materials, Travel, phone, internet, salaries, contractor hiring, Lease fees, rent, tools, uniforms, bonuses and commissions.

It's because of the complexity of tax deductable items that creative accounting can maximise perceived costs (including the creation of tax credits for a business that is seen to run at a loss).

The complexity of the corporate taxation system has allowed big business to avoid a large component of tax payment. The complexity also disadvantages small to medium sized business as the compliance overheads represent a greater proportion of dedicated man-hours while proving more difficult for smaller business to avoid.

The essence of corporate tax is that it is paid on profit and the multinational structures of big business allow the largest players to creatively reduce the accounting of profit (if doing so is advantageous).

Rethinking Corporate Tax

For many years, the philosophical basis of taxation was for those extracting wealth (or benefiting) from the economic system to contribute proportionately to the costs of maintaining government and society itself.

It is clear that our current taxation system rests upon the shoulders of small business with wage and salary earners, not the large corporate interests extracting the majority of wealth from the economy.

Separating business costs from income is central to the purpose of business taxation.

The problem with existing taxation has been the array of categorisation that allows for creative accounting. In turn, this has allowed major firms to suggest that they don't actually make profits at all. This is only possible because corporations, unlike private individuals, are not taxed on their actual income stream. The revenue streams for all Australian firms are unambiguous and not open for creative reinterpretation.

Corporate Income Taxation

Running any business is an expensive proposition. By itself, levying a 25% or 30% tax on the received income of a business would financially bankrupt most businesses as core running costs account for the Lion's share of any income. In keeping with the idea that expenses of running of a business must be accounted for prior to taxation levied, an income stream tax must be open to a wide interpretation of deduction to cover all reasonable business operating costs.

For conceptualisation of what a corporate profit really is, we should consider tax deductable expenses prior to a levying a tax rate upon income. This is not very different to what effectively occurs with most businesses. A 30% tax would occur after accountable business expenses were deducted from the declared income of a firm. Again, there is nothing unusual with this concept. The radical nature of this proposal is by scrapping a myriad of regulation on what is tax deductable and suggesting that by default, all business payments are tax deductable with a smaller subset of regulation declaring what is not.

Instead of trying to categorise what is tax deductable, a far simpler approach would be to declare what expenditure isn't.

A moment needs to be taken to consider the philosophical justification of taxation – at least from a left-wing perspective.

Progressive ideas in taxation fundamentally posit that taxation should be carried by those benefitting the most in society. Inversely, those struggling with little or no reward should be subject to tax reduction or exemption. As such, it's the concept of profit (or extraction of wealth) that is subject to tax… not the expense of remaining afloat.

As long as expenditure occurs with other Australian firms, sooner or later, the expenses of one firm become the profits of another & as profits of a second firm (wealth extraction) they become taxable. As a whole, the Australian Tax Office could adopt a wide lenience in accepting payment to other Australian firms as being both valid business expenses as at no point does a payment to an Australian firm represent an extraction of wealth from the economy as a whole.

Two principles are of paramount importance in this conceptual understanding.

- Those extracting wealth from the economy are in the greatest financial position to pay tax.

- Currently, those extracting the most wealth from the Australia economy (i.e. international profit shifting) are paying the least or even no tax at all.

As a general rule, the integrity of the tax system could remain intact if all business expenditure was tax deductable – as long as the expenditure was to another ATO registered firm. For the system as a whole, when profits are made they will be collectively taxed… regardless of which ATO registered firm is declaring a profit at any particular time. The advantage to this approach is that any international transfer of wealth remains tax liable, regardless of internal accounting. This is not necessarily intuitive but will be elaborated on further in the next section.

Tax Simplification

Consider the prospect of company taxation being simply levied as income minus all wages and all operational business payments made to Australian registered businesses. A much simpler set of rules could be used to declare that payments such as investments & entertainment expenditure were not core business costs & could not be claimed as tax deductable.

Payments or expenditure to foreign firms or entities would not be tax deductable as those organisations would effectively be extracting wealth from the economy without paying the company tax local firms are subjected to. If an Australian based firm wishes to engage the services of a foreign firm (as they are entitled to), the revenue from the Australian economy disappearing offshore must still be taxed in accordance with a corporate tax rate. The income stream of a company would remain taxed at a rough 30% without any form of discount on the payments it makes externally. This is not a tariff, nor is it an exchange control – it simply ensures that taxation is collected from all firms extracting wealth.

A simplified model of taxation would make tax avoidance much harder for big business in Australia. It would become impossible for the vast level of current tax avoidance to continue. If tax is uniformly applied on income with tax deductions only available on payments to ATO registered firms, multinational pricing arrangements, franchising and profit shifting becomes invalidated as a method of tax avoidance.

There are some major advantages of simplifying tax in this way.

- Overseas payments, for whatever current accounting mechanisms are ineligible as a tax deductable from income streams. This provides a considerable incentive for services and products to be sourced locally from firms that are contributing to the taxation base of the nation.

- Company tax could become progressive by graduating taxation on income thresholds in the same way personal taxation has traditionally been.

- Accounting becomes very simple. Tax filing requires declaring an income against wage payments and retained invoices to other Australian firms.

- GST could itself be abolished if corporate income streams were reliably subject to taxation. Any firm selling goods and services would have the income received from the sale of each individual item or services directly taxable. If GST were to be phased out and a progressive company tax introduced, small firms could be encouraged instead of being comparatively disadvantaged by compliance overheads as they are now.

Without modelling it's very difficult to estimate how much additional revenue would be captured by taxing company income (minus payments to other Australian firms). By preventing common forms of profit shifting by taxing all capital extracted from the system tens or even hundreds of millions of dollars could be potentially netted. Undoubtedly, the income recaptured from abolishing international profit shifting would be considerable.

There would require taxation rules and penalties for fraudulently declaring business expense or speculation trading under the guise of valid operating expenditure. However, developing regulation to prevent abuse surrounding an unfaithful accounting of business incurred expense would be easier than trying to regulate the internal accounting methodologies of multinational firms as the existing tax avoidance mechanisms require.

By shutting down the ability of big business to avoid tax, the government would have the luxury of considering the most effective application of tax within the economy.

Previous sections have shown the major benefits to the economy of small & medium sized business. With small business being almost completely Australian owned & with almost all expenditure with small firms being local to the Australian economy, a progressive tax free threshold with company income could have immediate advantages as an economic stimulative. Progressive company taxation could also recognise the comparative compliance overhead disadvantage that small business faces with big business competition. Questions could also be raised over the desirability and cost of compliance of GST as a taxation mechanism.

Simplified Taxation – Use Cases

As proposed, consider corporate tax levied on all income with tax deductions on expenditure if paid to other Australian registered businesses. The following scenarios provide a clearer understanding of how deducting all invoices to ATO registered firms from an income stream might work. Obviously the instinctive impulse is for any business owner to ensure as many business costs as possible are invoiced through other Australian firms.

Consider some of examples of the effect of the taxation on business.

1. A large company currently sells devices in Australia for $500 a unit while claiming $420 as a business cost (as it pays a subsidiary of a parent organisation offshore). In the simplified taxation model "costs" are not tax deductable – only business related payments to other firms registered with the ATO. The income of $500 per unit is fully subject to corporate income tax so the firm remains liable for approximately $150 tax per unit from the moment of sale.
2. An international IT firm earns a million dollars from Australian business for accessing its online services. Currently, the Australian section of the IT firm claims 99% of all income as costs that are transferred to its Singapore counterpart which provides service. Under the simplified taxation model, all income for the Australian subsidiary remains liable for company tax and as no payments are being made to other firms registered with the ATO, no tax deductions are available. The incentive for minimising the tax bill would be to establish an Australian operations data-centre where all costs related to servicing the infrastructure (staff, power, hardware replacement) would then be deductable from the tax bill.

3. An International IT Services firm currently undercuts local Service providers by maintaining the majority of their workforce offshore. Under the simplified taxation model, local service providers are able to tax deduct the wage bill of employees, electricity, rent and Australian purchased IT equipment from their income tax stream while the offshoring firm cannot. The taxation change would remove the ability of local firms to be disadvantaged by offshoring for cheap labour.
4. In an attempt to minimise company tax, a small business maximises salary and wage payments to increase tax deductions. The move would reduce the payable tax for the firm. If the transfer of income to wages was to a single individual, the effect on government tax take would be zero as the same tax would be gained from progressive taxation on the individual's wages. If however, the strategy was to increase the wages of multiple, lower income earners, government tax take would be reduced as their taxation is subject to progressive tax free thresholds. In this case, the strategy would reduce company tax but would increase wages and stimulate the internal economy by increasing disposable income in the domestic market.
5. In an attempt to minimise company tax, a business maximises it expenditure with other Australian firms by purchasing investments in shares, land and metals. Tax deductable status of payments to other firms can <u>only</u> be valid if the payments are the result of providing goods and services for which the business is incorporated. Tax deductable payments must explicitly exclude speculation, the purchase of land and assets not used toward the primary business purpose of the incorporated body.
6. A motor vehicle importer spends a million dollars importing vehicles for sale from overseas. The sale of goods will incur an approximate business tax component of 30% that must be factored into sales prices. The simplified tax model significantly increases the cost of imports although the potential for removing GST could soften the price hike. If a smaller motor vehicle importer were spend $100,000 importing vehicles in the same way, they receive a comparable advantage to their large competitor as a progressive company tax scale provides a great proportion of their income as tax free (or lower tax). The effect is to provide advantages to smaller business entities.
7. A farm operation accrues expenses of throughout the year – all paid to Australian firms for livestock, feed, animal services, energy and water. As all expenditure is within the national economy, all costs carry tax deductable status. No tax is due to be paid until after returns are made on the sale of livestock and progressive tax-free thresholds on company income ensure the business has minimal tax reprieve on income before any tax requirements occur. *If GST were to be removed as part of a tax simplification, the initial outgoings (and overheads) carried by the farm would be reduced.*
8. A private individual decides to sell home-made soap at a local markets. By registering a business, all costs related to the establishment of the small endeavour become tax deductible & the initial meagre earnings could be tax free by falling under a progressive Tax Free threshold for their company. If the small venture decides to retain the earnings within the company, they are untaxed through either company tax or through salary and wage tax. Alternatively, once income breeched tax free or low tax thresholds, an incentive then exists to increase outgoings to wages which would individually receive progressive taxation status.

Remember that these scenarios all occur as a result of banning profit shifting practices that currently allow tax avoidance within big business.

9.

Exceptions & Additional Regulation

The ability to reliably tax corporations occurs from having a very simple taxation framework. There are some areas that do need highlighting as exceptions, or potential issues, that would require specific regulation.

- An area that would require special regulation in regard to tax credit and charging is the finance industry. As part of core business Banks and Money exchange organisations can utilise their own foreign reserves. If subject to the same simplified taxation model, any purchase of foreign currency that did not pass through the Reserve Bank would be subject to an effective 30% tax. In a Keynesian context this I extremely beneficial for ensuring debt is localised and the government controls the exposure of reserves. At a practical level, this is probably unfeasible – especially considering the needs of travellers and tourists to exchange currency through banks without being subject to an effective 30% transaction tax. It is more likely that registered banking and currency exchange organisations would require specifically tailored regulations and taxation policy.

- Business debt would need consideration as to how it was treated under the proposed tax model. Currently only accrued interest is tax deductable otherwise firms would intentionally run their entire business in debt, earning tax deduction for all payments made to banks. This would also require payments made to banks and lending institutions to be covered under special regulation and tax deduction provision.

- Potential for progressive taxation & company tax free thresholds would be an obvious target for abuse unless regulations were tightened into cross-company ownership. A goods importer may well be tempted to form a separate company for every shipment of freight imported into the nation as the administrative costs of incorporation would be minimal compared to paying full tax. A large number of different mechanisms could be used to clamp down on such behaviour but would need implementation in conjunction with taxation reform.

Conclusion

Large scale corporate tax avoidance cannot be prevented without a major simplification of the tax system. Taxing an income stream directly instead of subjectively defined profit makes avoidance much more difficult while providing a simple tax deduction for all core business expenditure spent within the nation incentivises against shifting wealth offshore.

The adoption of corporate income tax would at least levy tax against all profit shifting – which by itself would gain at least $20 billion (from ATO estimates)… which is the equivalent of all Federal monies spent on General Public Services. The potential for increasing government revenue is likely to run into hundreds of millions of dollars if creative internal accounting was successfully eliminated.

Corporate tax advance is a major component of why state services and welfare have been drastically reduced over recent decades. Using income tax instead of a traditional tax on profit has the potential to tightly close loopholes that currently see extreme levels of wealth extracted from the economy & society at almost non-existent tax rates.