22 November 2017
Australia 2017/19

Tax Insights

US tax reform – What does it mean for Australia?

The first concrete measures on the road to possible US tax reform are going through the various machinations of the US Congressional and political system. During November 2017, there has been the release by the Ways and Means Committee of the Tax Cuts and Jobs Act (the Bill), that Committee's Chairman's amendments, and the "Senate Proposal" prepared by the Joint Committee on Taxation with subsequent amendments. There will be ongoing debate on the proposals before they are introduced into the US Senate.

Whilst there is no doubt a long way to go in this process, it is timely at this stage to focus on the international tax implications of the proposals in the context of Australian companies investing in the US and US companies investing in Australia.

The key proposals of interest to Australian businesses include:

- **Reducing the US corporate tax rate to 20%** and potential repeal of the alternative minimum tax (timing of introduction being debated but much sooner than the potential general reduction of Australia's corporate tax rate to 25% in 2026-27).

- **Supply chain and base erosion measures** – Base erosion anti-abuse taxes such as a 20% US excise tax on amounts paid by a US corporation (House) or a "base erosion minimum tax amount" (Senate). Notably, the proposed excise tax may not apply if the foreign recipients of the amount "elect" into the US tax system. These measures may be coupled with concessions allowing effective tax free transfers of offshore IP to the US (to encourage US "domestication" of intellectual property).

- **Stronger US Controlled Foreign Corporation (CFC) rules** – US tax on a current basis on 50% of a CFCs "foreign high return amounts" (House) or on "global intangible low-taxed income" (Senate).

- **Restrictions on interest deductions –** A cap on US interest deductions based on 30% of "adjusted taxable income" and provisions to address "excess US indebtedness", to limit the US gearing ratio to no more than 110% of the global group's ratio.

- **Anti-hybrid rules –** New US rules to deny deductions for payments made pursuant to a hybrid transaction or involving a hybrid entity. The rules are similar to, but more limited in scope compared those introduced in the UK and the EU and likely to be introduced in Australia.

- **Transitional tax on foreign accumulated earnings** – A transitional imposition of US tax (at up to 5% or 12%) on accumulated (post-1986) foreign earnings that have not been repatriated to the US or previously attributed under the CFC rules (timing of inclusion in US income being debated).

- **Effectively tax exempt foreign dividends** - A 100% deduction for dividends received in the US from 10% or greater owned non-US subsidiaries after 2017 (similar to a dividend participation exemption).

Australian based groups with US subsidiaries and Australian subsidiaries of US based groups should continue to monitor these developments. Based on the framework of the proposals, there are a number of key issues to begin considering.

As a general observation, the US now brings an additional (and perhaps competing) dimension to the ever-changing landscape of international tax rules around the world, largely prompted by the OECD's Base Erosion and Profit Shifting program. Where Australia's proposed measures and existing laws are (arguably) largely consistent with the OECD proposals, the US proposals introduce novel concepts to tackle similar concerns. Cross-border dealings with the US, funding arrangements, profit repatriation to and from the US, and additional US compliance requirements will need to be monitored closely.

Some of the specific considerations for Australian businesses are as follows:

Issues to consider for Australian based group with US operations

1. ***New relative tax rate paradigm, impact on group earnings and review of global structure*** - The US will flip from being one of the highest corporate tax rates in the world to a rate considerably lower than the current Australian rate of 30%. The tax rate differential on flows between Australia and the US companies could be up to 10% (subject to US state taxes). However, any potential reduction in the overall US tax rate and cash taxes might be tempered by the proposed base-erosion measures and other domestic tax law reforms.

   Further, aspects of Australia's international anti-avoidance rules (the multinational anti-avoidance law (MAAL) and the diverted profits tax (DPT)) which require consideration of a "liability to tax under foreign law" and "sufficient foreign tax" will be reframed in relation to arrangements involving the US.

2. ***Impact on US earnings*** – The various US domestic law reforms and the US rate reduction should be modelled to determine the impact on US profits and repatriation capacity, as well as to identify any flow-on accounting impacts.

3. ***Review debt levels in US operations*** – The change in tax rate, the tighter limitations on interest deductions and hybrid measures will require re-consideration of the capital structure of US operations. This may increase the debt burden and pressure on thin capitalisation limits for group companies in other countries, including Australia.

4. ***Review supply chains*** – The change in US corporate rates, coupled with the US base erosion measures will require an analysis of the impacts on existing supply chain arrangements. For example, there may be potential double taxation on payments from the US (e.g. proposed US excise tax) which may not give rise to a foreign income tax offset in Australia. Groups may also need to re-examine the location of intellectual property.

5. ***Pending restructures*** – Many Australian based multinationals with a US connection are currently considering restructuring their operational and financing arrangements in light of Australia's MAAL, DPT and proposed anti-hybrid rules. The proposed US changes add a significant additional element into any such restructures.

Issues to consider for Australian subsidiaries of US groups

1. ***Earnings management –*** The rules and cut-off date for the transitional repatriation regime will need to be monitored. Australian subsidiaries may be required to meet head office driven repatriation plans under the transitional measures. This may require planning in Australia to ensure that the Australian parent entity is in a position to

pay dividends in respect of profits generated by lower tier subsidiaries. In addition, the US characterisation of historic earnings may need to be undertaken to plan any repatriations under the transitional regime.

2. ***Future profit repatriation -*** Going forward, Australian companies should have an increased ability to pay dividends to a direct US parent free of US tax cost (and subject to the availability of franking credits, conduit foreign income or treaty protection to mitigate withholding tax on the Australian side). It may be that this leads to changes in global group holding structures.

3. ***Global supply chains may be re-configured -*** The roles and functions of US, Australian and intermediary entities in the global supply chain could be modified, including the ownership and functions attributable to intellectual property, due to the US changes.

4. ***Pending restructures –*** Any proposed group or supply chain restructures as a consequence of the US reforms will require an Australian analysis of new international anti-avoidance measures (DPT, MAAL, and proposed anti-hybrid rules), as well as consideration of Australian transfer pricing, general anti-avoidance provisions and double tax treaty matters, including impending changes via the Multilateral Instrument.

5. ***Australian capital structure –*** As a consequence of the reforms, including the new US interest restrictions, capital management issues may arise for the Australian operations, which will need to be managed, having regard to the ATO focus on cross border arrangements.

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