TRUMP, TAX AND AUSTRALIA
AUGUST 2016

Republican candidate proposes big changes in tax system

NAB Group Economics

Big cuts in corporate and individual taxation are key to Mr Trump's election platform, aiming to boost the business sector and deliver increased spending power across the income spectrum. As the US is such a large global economy and key partner for our trade and foreign investment, changes in US taxes have important potential consequences for Australian based business.

FAR REACHING TAX CHANGES PROPOSED

Donald Trump, the Republican candidate in the November US Presidential election, has set out the latest version of his economic plan in a speech to the Detroit Economic Club.

As he repeated trade policies already announced and we have already reported on these, we focus on his proposals for tax reform.

This tax reform agenda matters for Australia as:

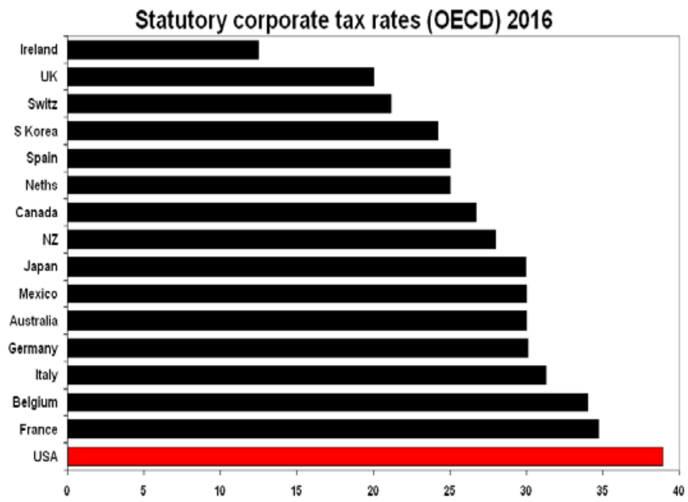
- If implemented as described, it would have a big impact on the US budget and economy and the US is the second largest economy in the world. It is Australia's third largest export market (worth $22 billion in shipments of goods and services) and a big competitor across a range of commodity industries:
- Cutting corporate taxes is a centre-piece of the proposed tax reforms and we have our own business tax reform agenda. Even if the corporate tax reform agenda outlined in May's budget were announced, Mr Trump's proposed cuts to the US tax would take statutory US company tax rates from being well above to well below Australia's, and
- Changing the tax arrangements for the taxation of the international earnings of US multi-nationals is also part of Mr Trump's agenda. Australia has a big interest here - the US is easily the biggest direct investor in Australia. US figures show that US multinationals with a controlling interest (50%+) in their Australian subsidiaries employed 310000 staff here in 2013 and there were another 50000 working in US companies with between 10% and 50% ownership.

BIG CUTS TO US COMPANY TAX

The US system of company tax comes under a lot of criticism and Mr Trump plans big changes. In particular he plans to cut the US rate of corporate tax from 35% to 15% but we have not seen a date by which that goal would be reached.

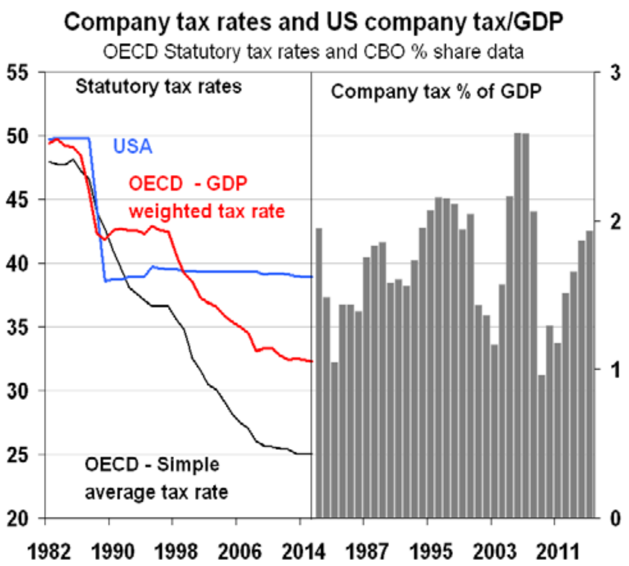
The US tax system is often criticised as levying far too high a rate of corporate tax – almost 40% when both Federal and State taxes are taken into account. This is well above the OECD average rate (which averages only 25% using a simple average of member country rates and around 32% when we take account of the size of OECD countries economies).

So the US rate is higher than in competing big high income countries and far above that in smaller low tax countries like Ireland (with its 12.5% tax rate), let alone tax havens in the West Indies. The outcome is that the US system takes a lot of flak for being destructive to both jobs and enterprise by imposing what are called "the highest business tax rates among the major industrialised nations of the world".



Date **August 2016** | Author **Tom Taylor** – Head of International Economics

This problem of higher than average US tax rates has been getting steadily worse for decades. Back in the early 1980s US company tax rates were pretty much in line with the OECD average but a series of company tax cuts across other OECD nations has driven a steadily bigger wedge between their rates and that of the US.



Mr Trump's proposed tax cuts would fundamentally change the relative position of the US corporate sector – it would shift from being the highest taxing OECD country to one of the lowest. Only Ireland with its 12.5% tax rate would be lower when it comes to taxes levied by the central government.

Even adding in the 6% US State level average of company taxes, the resulting 21% total US company tax rate stemming from Mr Trump's proposal would undercut those in its NAFTA neighbours. Canada has a 26.7% combined federal and provincial tax rate and Mexico has a 30% rate. The Federal Government's last budget outlined a strategy to cut Australia's company tax rate to 25% by the 2026/27 tax year. Even under this plan, we would go from having a central government tax rate on companies that was around 5 ppts below the US rate to one that was 10 ppts above the proposed US rate.

Just as the $48.2 billion cost of the Australian Federal Government's 10-year company tax reduction strategy received a lot of attention, so the budgetary cost of Mr Trump's plans has been under scrutiny. The Tax Policy Center looked into the fiscal impact of the proposed tax cut and found it would reduce US corporate tax receipts by around $US 2½ trillion between 2016 and 2026 and another $US 3¾ trillion between 2027 and 2036. These are very large amounts of money but they fall well short of the revenue cost of Mr Trump's proposed cuts to personal taxes.

REFORM US INTERNATIONAL TAX SYSTEM

The taxation of income earned abroad by US multinational corporations is one of the most criticised parts of its business tax regime. Much of this reflects the unusual nature of the treatment of foreign earned income in the US company tax system.

There are 3 ways countries can tax the foreign sourced income of their multi-nationals

- Allow it to be taxed in the country where the income is earned and only tax corporate profits that are earned in the US itself – a system called "**territoriality**"
- The home country of the multi-national taxes its profits, regardless of where they are earned – the "**worldwide**" system. A deduction is allowed for taxes paid overseas to avoid double-taxation so a US multi-national would pay 20% on its UK profits to the UK tax authorities, get a credit from the US tax authority for that payment and pay a top-up 15% to the US revenue. Not many countries use this approach, or
- The **hybrid US system** where taxes are levied on the worldwide income of US multi-nationals but the tax is only paid once they bring the money back into the US.

The combination of the relatively high US corporate tax rate with this unusual system of treating foreign sourced income – like that of the Australian subsidiaries of US multinationals – has led to all sorts of complications and controversies

- **(1) US multi-nationals simply hold onto their offshore earnings and defer repatriating them.** US firms can indefinitely defer bringing "active" income back into the US by holding it for reinvestment in their offshore operations. This has led to Fortune 500 firms holding around $US 2.4 trillion in cash in their foreign operations, what is called "trapped" money that cannot be brought back for use in their US operations without facing stiff tax bills, and
- This money is not, however, lost to the US economy – a survey found that around half of it had been sent back as bank deposits or investments in US assets like Government securities or the shares of other companies. Some US firms even combine massive offshore cash holdings with raising new debt in the US market to pay for acquisitions.
- (2) "**Inversions" – these are where US-based corporations turn themselves into foreign based ones** to benefit from paying lower

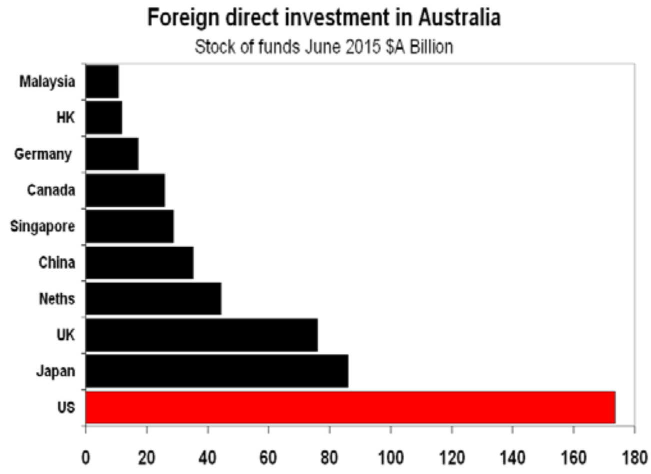
taxes in places like Ireland where they do not have to pay the 35% tax rate on foreign sourced income they would face in the US. This has been a hot political issue in the US in the wake of a number of big changes in where household name US corporations either tried or managed to become foreign based. The US Treasury has been tightening up the rules to make this harder and this was believed to have contributed to the cancellation of a big "inversion" that would have turned the US pharmaceutical firm Pfizer into an Irish-based company last year.

The US system of taxing foreign earnings is widely seen as needing an overhaul. President Obama has suggested introducing a 28% standard corporate tax rate plus a 19% minimum tax on foreign sourced profits that would be imposed as the money was earned rather than when it was repatriated. There would also be a once off concessional tax rate for US corporates who brought back their foreign cash.

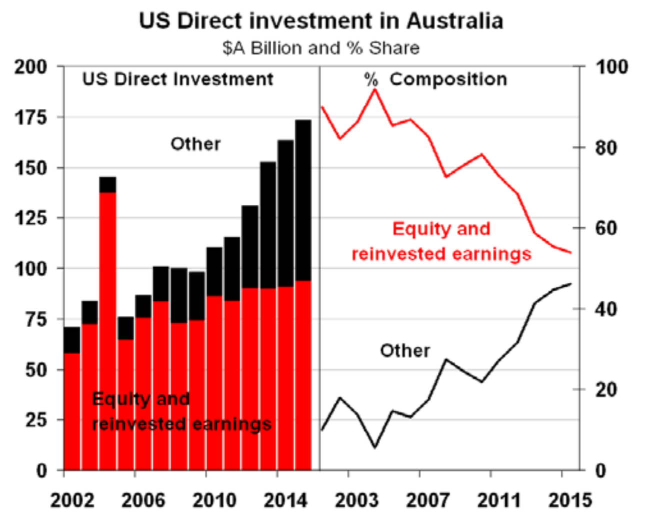
Mr Trump has had a lot to say on how he would reform this obviously unsatisfactory situation, suggesting he would:

- encourage US corporates to repatriate their "trapped" money by imposing a 10% tax on those funds - probably a very concessional rate as much money could be held in tax havens. "Repatriation holidays" have their supporters, but also their critics who say that a similar move in 2004 that gave a 5¼% tax rate gave disappointing results and gives the most benefit to US firms holding their foreign assets as cash in tax havens: and
- reform the US tax system so that it no longer benefits companies planning to move their legal HQ abroad. The proposed cut in company taxes to 15% should cut the number of "inversions" but Mr Trump has not said much about the raft of rules the US Treasury have also been implementing to make it harder for US corporations to change their nationality for tax purposes: and
- Although there is a lot of support in the US corporate sector for the US to adopt a territorial system of taxing foreign sourced income (which would probably mean that it was not actually taxed), Mr Trump has in the past called for retention of the worldwide system of taxing US firms. Under his plan US firms would still have to pay a 15% tax on foreign profits but the Republican Party platform was announced in July and it called for a territorial system of taxation. We will have to see how this all pans out – whether Mr Trump adopts the party platform or vice versa and what can be got through Congress.

Tax and regulatory changes that affect US multinationals can matter a lot for Australia. The US has easily the biggest stock of direct investment in Australia of any country - $A 174 billion in mid-2015, around one-quarter of the entire stock and more than double the second ranked country (Japan).



Moreover, this stock of US direct investment in Australia has been ramping up for a decade and the 2015 sum was double that of 2006. The mix of these US funds has also been changing over time with a shift away from foreign equity and reinvested earnings and toward other types of assets (in which presumably debt has become more prominent). Equity-type funds comprised around 90% of US direct investment 15 years ago, now they are barely half.



As Australia is a comparatively high taxing country when it comes to corporate earnings, it has never been in the firing line of US critics of its tax policies in the way that places like Ireland have. US corporations that shifted the location of their legal HQs went to far lower taxing countries than Australia. Indeed, much of the debate here has been on foreign-controlled corporates allegedly loading debt and fees onto their Australian subsidiaries to purportedly shift profits offshore into lower tax jurisdictions rather than for foreign controlled companies to shift profits into Australia. This concern underpinned the diverted profits tax and the new rules on transfer pricing in May's Federal Budget.

While Australia is not one of the low tax jurisdictions that are concerning US politicians, US controlled corporations are so important here that close attention should be paid to actual or prospective changes in the rules they face at home. If the US corporate tax rate were cut to 15%, it could alter the timing of and paths through which profits flow from Australian operations back to US based parents. Any shift toward a territorial system of US corporate taxation could mean no more US tax has to be paid on Australian sourced income but if the US rate were cut to 15% it would be below the likely Australian rate and so no top-up tax would have to be paid to the US revenue anyway.

PERSONAL TAXES AND ECONOMIC IMPACT

While Mr Trump's proposed reductions in corporate taxes involve plenty of dollars, the really big sums should come with his proposed cuts in personal taxes. His original plan to replace the current 7 US tax brackets with just 3 and significantly lift standard tax deductions would have involved big cuts in taxes. Millions more Americans would end up not paying any income tax at all and the Tax Policy Center costed the full-Trump tax plan for individuals as costing \$US7½ Trillion between 2016 and 2026, rising to \$US 11½ Trillion in the following decade.

Making things more confusing, the US House of Reps Republicans came up with an alternative less generous set of proposed tax cuts for US individual taxpayers. In his Detroit speech, Mr Trump said he would adopt some of the Republican party's alternative tax plan, but not all of it so there could be agreement in some areas but not in others.

Changes to US individual tax rates have less immediate impact on the Australian economy than Mr Trump's proposals for foreign trade rules or taxes but they could have important indirect effects. These indirect effects stem from

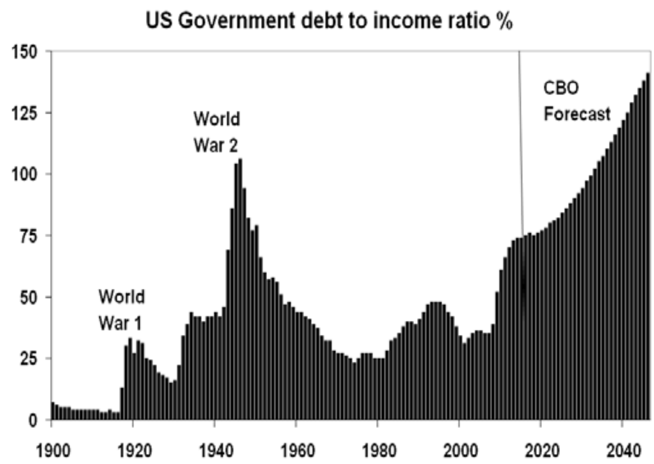
- the impact of the tax changes on US growth, US interest rates and the US Dollar, and
- how the tax changes affect the US budget deficit and debt

There would then be consequences for global interest rates, currencies, US inflation and the level of demand that impact on our bond yields, the \$A/\$US exchange rate and the demand for our exports.

Concerns with Mr Trump's proposed tax policy are:

(1) **impact on the US fiscal deficit and public debt**. The US budget deficit was wound back from almost 10% of GDP in 2009 to 2½% in 2015 but the fear is that the outlook for higher spending on health care and welfare will see deficits widen again. Even without any tax cuts, the Congressional Budget Office (CBO) forecasts the annual deficit to widen from 2.9% in 2016 to 3.9% over 2017 to 2025, 6.2% over 2027 to 2036 and 8.1% over 2037 to 2046.

The problem is that the US government is already highly indebted by historical standards and the situation is expected to just get worse, even without adding in anyone's proposed tax cuts. The US government debt to GDP ratio has already risen from 35% a decade ago to 75% and the CBO predicts it to rise to 86% by 2026, 110% by 2036 and 141% by 2046, not far off Italy's current ratio. The Tax Policy Center estimates that unless Mr Trump's tax cuts are offset by spending cutbacks – a big ask if health and welfare are quarantined from cuts – they could add a further 39 ppts to the US debt to GDP ratio by 2026 and 80 ppts by 2036.



(2) **impact on interest rates and currencies** - Such a ramping up in the US public debt ratio could lead the ratings agencies to have a very close look at whether downgrades are required and bond yields to rise as larger risk premia are built in.

The initial impact of the tax cuts could give a sugar hit to US demand but, as labour markets tighten and wage and price pressures start to emerge sooner than otherwise, the Fed would be expected to start lifting US interest rates. Moody's have run their econometric model and found that the US\$ could appreciate in such a climate, leading to rising interest rates and currency appreciation that progressively offsets some of the initial sugar hit to demand. The outcome could be upfront benefits for our exporters as the \$US rises and tax cuts boost US demand.

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