Public Tax Transparency

What the numbers do and don't mean

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Appropriate public transparency of tax information for publicly listed companies is a critical part of building public confidence in the tax system. Public disclosure should educate the public about large business compliance with Australia's tax laws and build confidence that Australian businesses are doing the right thing. Any information that is disclosed to the public should be presented in a way that can best achieve these objectives.

This is not always easy to achieve. Since 2015, the Commissioner of Taxation has published total income, taxable income and income tax payable figures for all public and foreign owned corporate tax entities with a total income over $100 million and private groups with turnover greater than $200 million. This reporting of entity tax information is intended to discourage large companies from engaging in aggressive tax avoidance practices and provide more information to better inform public debate on tax policy[1]. Although we support the objectives of this measure, the interaction of complicated tax and accounting rules and the number of steps required to move from total income to taxable income to tax payable can lead to confusion around what those particular numbers mean – and don't mean.

This publication is aimed at making these numbers more meaningful to the public whilst also addressing some of the more common misunderstandings around what certain headline numbers really mean.

Total income or turnover is not always relevant in determining how much tax a company should pay

Total income disclosed on a tax return and is also referred to as gross income, gross turnover, turnover, revenue or gross revenue. It is not the same as profit. Total income is essentially the gross amount derived from selling goods and services <u>before</u> taking into account the expenses incurred in deriving that amount. In other words, total income does not take into account costs (such as wages, finance costs, the cost of goods sold or other expenses) incurred in earning that total income. A company with a large total income figure will not always translate to profits or tax payable. In fact, according to the Australian Tax Office between 20%-30% of economic groups listed on the ASX incur a loss each year, so you would expect similar numbers are not paying tax as a result.[2]

What this means is that only in the very rare case where a company derives total income without incurring **any** expenses would multiplying total income received by 30% give you a meaningful measure of tax performance.

Total income also includes certain types of income that are not subject to Australian tax, which are concessionally taxed, have a tax offset applied to them, which are taxed in the hands of shareholders or are Government imposts such as excise. These include:

- Certain foreign dividends received from subsidiaries operating in foreign jurisdictions.
- Profits from foreign branch operations operating in foreign jurisdictions.
- Franked dividends received from Australian companies.
- Income that is concessionally taxed such as offshore banking unit income.
- Income from property trusts that is taxed in the hands of the beneficiaries at their marginal rate rather than at the corporate level.
- Unrealised gains from asset revaluations.
- Excise on products sold (such as petroleum and tobacco excise) even though the full amount is remitted to the Government.

Tax is payable on taxable income not accounting profit

Although there are similarities between how accounting profit and taxable income are determined, they are different concepts. To assume a company should be paying 30% tax on its accounting profit in a particular year can be misleading in the vast majority of cases.

It is helpful to remember that company tax is levied on taxable income according to taxation law, while accounting profit is measured according to accounting standards which are governed by corporations law. The differences in accounting profit and taxable income are broadly attributable to the different objectives behind the accounting and tax regimes:

- Accounting rules are aimed at providing investors and regulators with an accurate picture of the economic state of a company at a single point in time, being the company's year end. Accounting profit tries to match the derivation of income with the incurring of expenses on that income. Some accounting standards require certain assets to be revalued at market value and any movement in that value from year to year is reflected in accounting profit or loss, even though that gain (or loss) has not been realised.

- Tax rules are generally more "binary" and look at income separately than expenses, and thus don't always "match" in an accounting sense. Tax rules look at the "derivation" of income or whether an expense is "incurred". Tax rules can also have a policy element to them. For example denying some deductions (such as fines) or accelerating a deduction to stimulate economic activity (such as the recent full expensing measure).

Taxable income and accounting profit are different concepts

Taxable income is defined as assessable income less allowable deductions. It varies from accounting profit due to policy decisions made by Governments that are embedded in tax law design to either encourage or discourage certain types of economic behaviour. For example, penalties are not deductible and 100% tax depreciation is allowed in the first year for assets used in a business even though the asset may be used over a number of years. Other income received such as foreign dividend income is included in accounting profit, but is treated as exempt income for tax purposes as the income has already been taxed in the foreign jurisdiction and to tax it again would amount to double tax.
These differences almost invariably result in a company's tax liability not equalling 30% of accounting profit. Accountants classify the differences in the calculation of taxable income and accounting profits as permanent and temporary (or timing) differences.

What are the most common permanent differences?

Permanent differences generally reflect policy outcomes such as when the tax law does not assess amounts to tax, applies a different rate of tax or does not allow a tax deduction. Examples of permanent differences include:

- The tax differential on profits derived in countries that have a tax rate that differs from 30%.
- Certain profits derived by "stapled groups" such property trusts which are not taxed at the company level but in the hands of the unit holders.
- Concessionally taxed income from operating an offshore banking unit.
- Receipts of franked dividends.
- Receipts of certain exempt dividends from foreign subsidiaries.
- Profits or losses derived from foreign branches.
- Income from complying superannuation funds which is beneficially owned by policy holders is shown as income of some insurance companies and taxed at 15% rather than 30%.
- Research and Development incentives.
- Non-deductible penalties.

- Adjustments for non-deductible interest expense under thin capitalisation rules.
- Certain capital gains and losses on disposal of interests in foreign entities.
- Utilisation of prior year income or capital losses where a current or deferred tax asset is not currently recognised for accounting purposes.
- Current year and carry forward tax losses that for accounting purposes are not seen as recoverable as it is unlikely future profits will be generated to utilise them.
- Non-employee entertainment.
- Accounting provisions booked in prior years in relation to tax disputes where the amount finally paid or refunded differs from the accounting provision.

What are the most common temporary (timing) differences?

Temporary (or timing) differences arise on items which are assessable or deductible for both tax and accounting purposes, but the point in time at which the amounts are assessable or deductible is in a different financial year for tax purposes than is booked as income or an expense in financial statements.

Examples of temporary differences include:

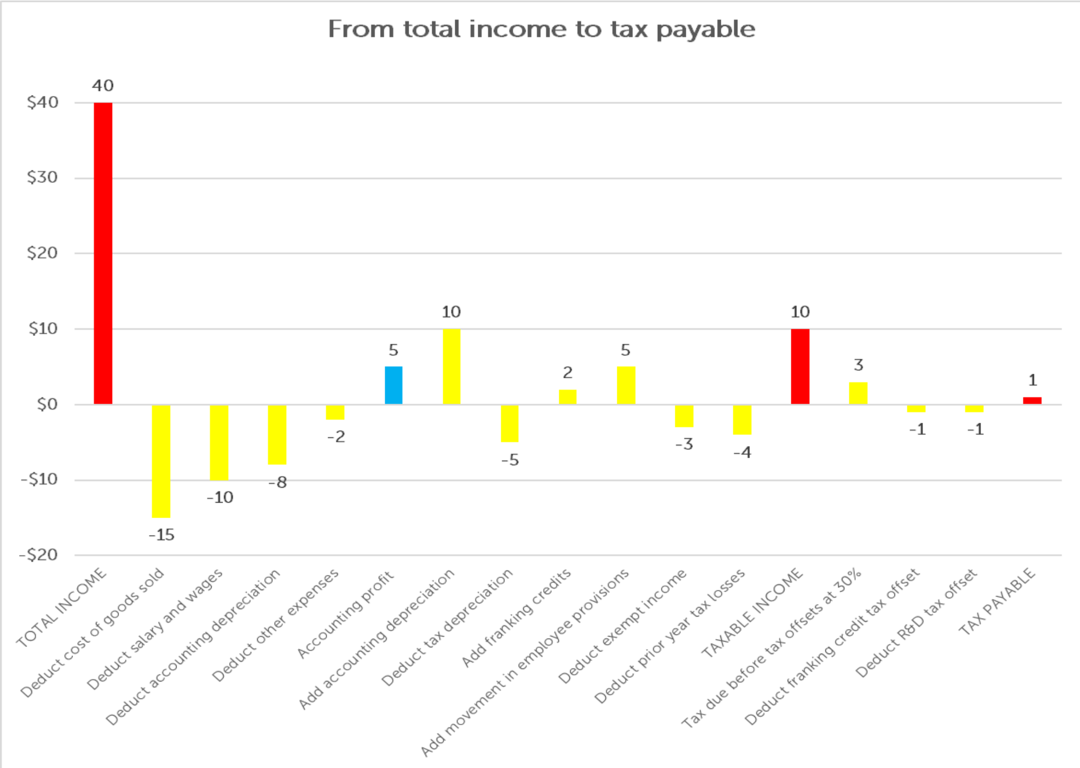
- Income for accounting purposes may be booked in a different period than is assessed for tax purposes (e.g. interest income is generally assessed for tax when it is received, but for accounting purposes when it accrues).
- Differences in book and tax depreciation rates reflecting a deduction can be claimed for tax purposes over a different period than for accounting purposes, albeit the total amount that can be deducted for book and tax purposes is the same.
- Employee entitlements such as superannuation, long service leave and annual leave which are deducted in calculating accounting profit as they accrue but are only tax deductible when long service leave and annual leave entitlements are paid.
- Prepayment of expenses which can be treated as an asset for accounting purposes but a proportion may be deductible for tax in the year of the prepayment.
- Accounting provisions for bad and doubtful debts which are deducted in calculating accounting profit as they accrue but are only deductible for tax purposes when the debt is considered bad.
- Accounting rules which deduct certain costs on an accruals basis but tax rules that only grant a tax deduction when expenses are incurred.
- Foreign exchange gains and losses which are generally only assessable or deductible for tax purposes when the gain or loss is realised, whereas accounting rules treat both realised and unrealised gains and losses as impacting profit and loss at year end.
- Operating and finance lease payments are generally deducted for tax when incurred, whereas accounting rules may deduct them over the lease term or treat the lease payments as part interest expense and partly a notional depreciation charge.
- Utilisation of carry forward tax losses that have been previously booked for accounting purposes.
- Some costs are booked on the balance sheet rather than expensed in the profit and loss statement for accounting purposes but may be deductible for tax purposes as incurred (for example certain costs such as interest maybe paid in one year but capitalised for accounting purposes and depreciated over a number of years for accounting purposes but are deductible for tax purposes when paid).

Such temporary differences are reflected in financial accounts via the booking of provisions for current tax and provisions for deferred tax liabilities (where tax will be paid in the future) or current and deferred tax assets (where items such carry forward losses are expected to reduce future tax payments).

The relationship between total income, taxable income and tax payable

The diagram below shows a simple example of the build-up from total income to accounting profit and some of the tax adjustments that may be required to calculate taxable income and finally income tax payable of a hypothetical company. The red columns highlight the three figures that are publicly disclosed and show they reflect only a part of the total income tax picture.

The blue column is the accounting profit of the company which is the total income figure less costs incurred in deriving that income. The yellow columns represent the adjustments that are made to accounting profit to arrive at the taxable income figure, and then after adjusting for tax offsets (such as franking credits and the R&D incentive), resulting in the amount of income tax payable.



A company's effective tax rate will rarely equal 30%

A company's effective tax rate is generally not equal to the statutory rate. This is due to the interaction of the tax and accounting rules outlined above. Publicly listed companies as a matter of course explain any variation in tax liability from the 30% statutory rate in their published accounts as well as providing data on taxes paid during the year in cash flow statements.[3] Some companies also provide further breakdown and analysis of their tax position in other publications such as under the Board of Taxation's voluntary tax transparency code.[4]

The disclosure of total income, taxable income and tax payable does not give an accurate picture of a company's tax performance or its tax performance relative to other companies

We have highlighted in the following table a simple example of three hypothetical companies showing data of total income, accounting profit, taxable income and tax payable. We have assumed all three companies operate in the same industry, have derived the same accounting profit however their total income and total accounting expenses vary. It also assumes the companies are at different stages in the investment cycle and thus their respective accounting and tax depreciation amounts, carry forward losses and tax offsets for research and development are different.

	Tax return for the year ended 30 June 2019	A Ltd	B Ltd	C Ltd
Label on tax return	Description on tax return	$m	$m	$m
6S	Total income	300	600	900
6Q	Total expenses	150	450	750
6T	Total profit or loss	150	150	150
	Tax adjustments			
	- depreciation	-50	0	50
	- carry forward losses	-50	0	0
7T	Taxable/net income or loss	50	150	200
T1	Tax on taxable or net income	15	45	60
E	Refundable tax offsets (R&D)	-4	-2	-1
T5	Tax payable	11	43	59
	Tax payable divided by total income	4%	7%	7%
	Tax payable divided by taxable income	22%	29%	30%

As the table shows, tax adjustments and tax offsets are driving the tax outcome. A Ltd has the same accounting profit as B Ltd and C Ltd, but because its tax depreciation is higher than accounting depreciation and it has carry forward losses for this particular period, it is paying less tax than B Ltd and C Ltd. The fact that A Ltd's ratio of tax payable to total income is 4% whereas B Ltd and C Ltd have ratios of 7% is not evidence of tax avoidance. Similarly, the fact that A Ltd has a ratio of tax payable to taxable income of 22% and that this is lower than B Ltd (29%) and C Ltd (30%) does not mean it is avoiding up to 8% more tax than its competitors.

What these numbers do show is that even in a very simple example careful analysis is needed to understand the drivers of tax outcomes. It shows that a narrative around the industry in which a company operates, the stage of the investment cycle it is in and other factors (which could include carry forward losses, for example) is critical in assessing if a company is paying the right amount of tax. Focussing purely on the numbers does not paint a full and accurate picture of a company's true tax position.[5]

In this regard the Corporate Tax Association (CTA) supports the Board of Taxation's voluntary tax transparency code which provides corporates with an opportunity to better educate the public about their tax performance. The CTA also strongly recommends that the accounting profit and loss figure disclosed on the company tax return form part of the ATO's annual reporting of tax entity information. This will provide a more meaningful insight into corporate tax outcomes and will reduce the scope for the published information to be misinterpreted.

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The Corporate Tax Association is the key representative body for major companies in Australia on corporate tax issues. Its objectives are to:

- increase community and Government awareness around the effectiveness and integrity of the Australian corporate tax system and the significant and ongoing contribution large business makes to Australia
- influence and develop tax policy that contributes to a corporate tax system under which large corporates cooperatively meet their tax obligations within a globally competitive tax system
- improve the administration of the corporate tax system and reduce the cost of compliance
- facilitate the implementation of best practice among our members by promoting corporate transparency and assisting and supporting them in their interactions with the Australian Taxation Office, the Treasury and Government
- provide ongoing peer support and thought leadership through an ongoing program of initiatives aimed at supporting its' professional development

End Notes

1 See the Explanatory Memorandum accompanying the Tax Laws Amendment (2013 Measures No. 2) Bill 2013

2 See ATO website which discusses the matter at reporting of entity tax information

3 Companies that are publicly listed outside of Australia provide the same analysis of tax liabilities relative to their home country tax rate

4 Details on the tax transparency code can be found at: Voluntary tax transparency code

5 Further explanation of public tax transparency data can be found on the ATO website at: Tax transparency - reporting of entity tax information.