

# Dividend Imputation and BEPS

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## Abstract

This study investigates whether dividend imputation mitigates Australian listed companies' incentives to avoid tax, and whether Australian subsidiaries of foreign multinational enterprises (ASFMs) engage in tax avoidance via base erosion and profit shifting (BEPS).

The prevalence of tax avoidance by multinational enterprises via BEPS has been widely recognised in the literature. In this study, we argue that dividend imputation mitigates the incentives of Australian listed companies, especially those with mainly domestic operations and domestic ownership, to engage in BEPS. With dividend imputation, Australian companies can pass their Australian income tax paid to Australian shareholders as a franking credit tax offset to reduce shareholders' personal income tax. Thus, for Australian listed companies with mainly domestic operations and domestic ownership (ALCDs), corporate profits distributed as dividends are effectively only taxed at the personal tax rates of their Australian shareholders, and corporate managers would have little incentive to engage in BEPS to avoid corporate tax which is a prepayment of shareholders' personal tax. In contrast, foreign-owned Australian companies would have strong incentives to avoid Australian income tax via BEPS because their foreign parents cannot access franking credits.

We test the above predictions by comparing a few ratios that indicate profit shifting activities of a sample of ASFMs with a sample of ALCDs which have no more than 20% of their assets located outside Australia. Specifically, we investigate whether ASFMs engage in intra-group transfer pricing and/or use thin capitalisation (two main practices to shift profits) to a greater extent than ALCDs. We predict that ASFMs have lower gross profit margin and lower earnings before interest and tax (EBIT), and/or higher interest expense (all expressed as ratios to sales revenue) and higher leverage ratios than comparable ALCDs as a result of engaging in BEPS. We also predict that ASFMs have lower pre-tax profit and lower income tax expense expressed as ratios to sales revenue than comparable ALCDs, as a result of successful profit shifting and tax avoidance.

We match ASFMs with ALCDs based on industry affiliation and firm size and perform paired-sample *t*-tests. We find that ASFMs have significantly lower gross profit margin, lower EBIT, lower pre-tax profit, and lower income tax expense than comparable ALCDs. However, no significant difference is found between ASFMs and ALCDs in terms of interest expense and leverage ratios. The results suggest that ASFMs engage in more profit shifting activities using intra-group transfer pricing to avoid tax than comparable ALCDs, and this phenomenon can be largely attributable to the foreign ownership of ASFMs.

This study contributes to the literature about (a) corporate tax strategy in a dividend imputation system and (b) BEPS, and the findings have significant policy implications.