
The Parliament of the Commonwealth of Australia

Report on the inquiry into tax deductibility

House of Representatives
Standing Committee on Economics

June 2017
Canberra

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ISBN 978-1-74366-462-9 (Printed version)

ISBN 978-1-74366-463-6 (HTML version)

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Chair's foreword

The committee's review focussed on enhancing compliance in relation to tax deductions. The committee noted that \$100 million of abuse was identified in a single year by the Australian Taxation Office (ATO), through a review of the Work-Related Expenses (WREs) claims of about one in one thousand taxpayers. The committee sees considerable scope for improvement in this area and has recommended the ATO review its compliance activity in relation to WREs.

The committee's view is that the ATO should remain proactive in identifying areas that are at risk of systemic abuse. Accordingly, the committee recommended that the ATO be instructed to analyse each detailed subcategory of tax deductions and identify areas that it believes are particularly open to systemic abuse and overclaiming. The ATO should then rank these subcategories in order of the size of the financial risk they represent to Government revenue, and recommend amendments to law or policy where appropriate.

The committee also considered options to simplify the personal and company income tax systems, and examined options to broaden the base of these taxes in order to fund reductions in marginal rates. In particular, the committee's review examined the areas of WREs and interest deductibility.

While the committee sees opportunities to improve the operation of the tax system, and has recommended changes to strengthen compliance, the committee supports the ongoing ability of Australians to claim legitimate deductions.

In relation to WREs, the committee saw little rationale for altering existing arrangements that allow Australians to claim personal income tax deductions for valid WREs. WRE deductions represent only 4 per cent of individual and other withholding tax revenue. This means that even the complete abolition of WRE deductions would only cover the cost of a very modest reduction in personal income tax rates.

Figures currently provided by The Treasury show that, in 2014-15, there were \$21.8 billion in WRE deductions claimed, comprising almost two-thirds of total deductions. However, this is not an indicative cost to the Budget of WREs because the amount a person receives is calculated based on their taxable income. It is for this reason that the Parliamentary Budget Office (PBO) was asked to provide the total value of selected income tax deductions and estimates of the revenue forgone from these deductions. While the PBO provided a general estimate of the cost to government revenue of WREs, The Treasury was unable to provide a confirmed figure.

In the committee's view, it is important that the actual cost to government revenue of WREs is clearly understood in order to inform budget planning. It is for this reason that the committee recommends The Treasury provides a clear estimate of the actual cost to Government revenue of WREs so as to properly inform policy in this area.

The committee heard that while significant compliance burdens are associated with Australia's personal income tax system, technological advancements are assisting with simplifying taxpayers' experiences in claiming deductions and lodging their tax returns. The committee has recommended that the ATO continue with this work, which shows promise in utilising technology to streamline tax processes.

In relation to company income tax deductions, the committee saw no evidence for change. The committee recognised the potentially significant negative effects that may result from change to deductibility arrangements, particularly in relation to investment in the Australian economy. As a consequence of this, the committee recommended that current arrangements should be retained.

The committee also noted the significant work currently being undertaken by the Government on the implementation of the G20/OECD Base Erosion and Profit Shifting recommendations. The committee recommended that the Government continue its important work in this area. This will further strengthen Australia's robust rules addressing tax integrity.

David Coleman MP
Chair



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Membership of the Committee 44th Parliament

Chair	Mr David Coleman MP (from 11 March 2016)
	Mr Craig Laundry MP (from 13 October 2015 to 18 February 2016)
	Mr John Alexander OAM MP (to 12 October 2015)
Deputy Chair	The Hon Ed Husic MP
Members	Mr John Alexander OAM MP (from 13 October 2015)
	Mr Scott Buchholz MP
	Dr Jim Chalmers MP (to 19 October 2015)
	Mr Pat Conroy MP
	Dr Peter Hendy MP (to 12 October 2015)
	Mr Kevin Hogan MP
	Mr Craig Kelly MP
	Mr Craig Laundry MP (to 24 February 2016)
	Ms Clare O'Neil MP (from 19 October 2015)
	Mr Clive Palmer MP
Ms Fiona Scott MP (from 2 March 2016)	
Supplementary Member	Mr Andrew Giles MP



Membership of the Committee 45th Parliament

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Inquiry Secretaries	Dr John White (from 20 March 2017) Ms Samantha Mannette (until 17 March 2017)
Researcher	Ms Marina Katic
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Office Manager	Ms Jazmine Rakic



Terms of reference

On Tuesday 1 December 2015 the Treasurer, the Hon Scott Morrison MP, asked the Committee to undertake an inquiry into the simplification of the personal and company income tax system.

Terms of reference

The Committee will examine some options to simplify the personal and company income tax system, with a particular focus on options to broaden the base of these taxes in order to fund reductions in marginal rates. Matters to be examined include:

- The personal tax system as it applies to individual non-business income, with particular reference to the deductibility of expenditure of individuals in earning assessable income, including but not limited to an examination of comparable jurisdictions such as the United Kingdom and New Zealand; and
- The company income tax system, with particular reference to the deductibility of interest incurred by businesses in deriving their business income.

The committee had not reported when the House of Representatives was dissolved on 9 May 2016. The Treasurer, the Hon Scott Morrison MP, re-referred the inquiry on the 22 November 2016 and asked that it be concluded.



List of abbreviations

ABA	Australian Bankers' Association
ACCI	Australian Chamber of Commerce and Industry
ACOSS	Australian Council of Social Service
AFTS	Australia's Future Tax System
ATO	Australian Taxation Office
AVCAL	Australian Private Equity and Venture Capital Association
BEPS	Base Erosion and Profit Shifting
BTWG	Business Tax Working Group
CAFBA	Commercial Asset Finance Brokers Association of Australia
FBT	Fringe Benefits Tax
ITAA	Income Tax Assessment Act
OECD	Organisation for Economic Co-operation and Development
PAYG	Pay-As-You-Go
PBO	Parliamentary Budget Office
TJN	Tax Justice Network Australia
WRE	Work-Related Expense



List of recommendations

2 Personal income tax deductions

Recommendation 1

The committee recommends that the Government maintain the current personal income tax framework that allows Australians to claim deductions for valid expenses, including those related to their work. The committee sees this as an entirely appropriate part of our taxation system.

While there are opportunities to improve the operation of the system, the committee supports the ongoing ability of Australians to claim legitimate deductions.

Recommendation 2

The Committee recommends that the Australian Taxation Office be instructed to analyse each detailed subcategory of tax deductions and identify areas that it believes are particularly open to systemic abuse and overclaiming.

The Australian Taxation Office should then rank these subcategories in order of the size of the financial risk they represent to Government revenue, and recommend amendments to law or policy where appropriate.

Recommendation 3

The committee recommends that Treasury be required as a matter of priority to provide a clear estimate of the actual cost to Government revenue of Work Related Expenses as necessary to properly inform policy in this area.

Recommendation 4

The committee recommends that the Australian Taxation Office review its compliance activity in relation to Work Related Expenses. The fact that

\$100 million of abuse was identified in a single year through a review of one in one thousand taxpayers suggests that there is considerable scope in this area.

Recommendation 5

The committee recommends that the Australian Taxation Office continue with technological development and progress on pre-filing of returns to support the implementation of the reform agenda and to simplify taxpayers' interaction with the tax system, with the eventual goal to minimise, and ultimately remove, the need for taxpayers to amend pre-filled returns.

3 Company income tax deductions

Recommendation 6

The committee recommends that the Government maintain the current company income tax framework that allows the deductibility of interest incurred by businesses in deriving their income.

Recommendation 7

The committee recommends that the Government continue its important work on the implementation of the G20/OECD Base Erosion and Profit Shifting (BEPS) recommendations to further strengthen Australia's rules addressing tax integrity.

Introduction

- 1.1 On 1 December 2015, the Treasurer, the Hon Scott Morrison MP, referred an inquiry to examine options to simplify the personal and company income tax system, with a particular focus on options to broaden the base of these taxes in order to fund reductions in marginal rates. The matters to be examined include:
- the personal tax system as it applies to individual non-business income, with particular reference to the deductibility of expenditure of individuals in earning assessable income, including but not limited to an examination of comparable jurisdictions such as the United Kingdom and New Zealand; and
 - the company income tax system, with particular reference to the deductibility of interest incurred by businesses in deriving their business income.
- 1.2 The committee had not reported when the House of Representatives was dissolved on 9 May 2016. The Treasurer, the Hon Scott Morrison MP, re-referred the inquiry on the 22 November 2016 and asked that it be concluded.

Conduct of the inquiry

- 1.3 A total of 36 submissions were received and are listed at Appendix A.
- 1.4 The committee held a roundtable public hearing on 5 February 2016, and a public hearing with the Australian Taxation Office (ATO) and The Treasury in Canberra on 15 March 2017. The witnesses who appeared are listed at Appendix B. The submissions and transcript of the public hearings are available on the committee's website at: www.aph.gov.au/economics.

Past and current inquiries

- 1.5 Australia's system of tax deductions together with company and personal income tax rates has been the subject of previous reviews, most recently the Australia's Future Tax System Review (Henry Tax Review) and the Business Tax Working Group. These issues have also been discussed as part of the *Re: think* Tax Discussion Paper, March 2015.

Australia's Future Tax System Review (Henry Tax Review) – December 2009

Work-related expense (WRE) deductions for individuals

- 1.6 The Australia's Future Tax System (AFTS) Review emphasised the need for fairer, more efficient and simpler personal taxation.¹ It stated that the centrepiece of personal taxation should be a high tax-free threshold with a constant marginal rate for most people and that the personal income tax system should support workforce participation by limiting high effective tax rates, especially for those people who are likely to be most responsive to financial incentives to work.²
- 1.7 In relation to the rules around tax deductibility, the AFTS Review noted that the rules in the personal income tax system have become extremely complex, which can hide the policy intent of the personal income tax system from citizens.³
- 1.8 The personal income tax system allows deductions for the costs incurred in producing income. For employee income this provides for the deductibility of WREs, including expenses for self-education associated with earning income. For the self-employed this involves the deductibility of expenses *incurred* in producing their assessable income, and expenses *necessarily incurred* in carrying on their business to produce income.⁴
- 1.9 The AFTS Review noted the principle that:
- Earned income subject to taxation should be net of the costs directly incurred in earning that income. Work-related expenses

1 Australian Government, *Australia's Future Tax System, Final Report, Part 1, Overview*, December 2009 (released 2010), p. 29.

2 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 11.

3 Australian Government, *Australia's Future Tax System, Final Report, Part 1, Overview*, December 2009, p. 30.

4 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 53.

should be clearly defined as those that are necessary to produce income.⁵

- 1.10 The AFTS Review discussed that the intention of WRE deductions is to improve the equity of tax treatment between those who incur costs in producing their income and those who do not. The AFTS Review then suggested however that it is unclear that WRE deductions are necessary to maintain this type of equity, explaining that if they were no longer available it is likely that wages would rise or that expenses would be met by employers rather than employees.⁶
- 1.11 On an international comparison, the AFTS Review found that the Australian tax system is relatively generous in providing WREs. Deductions for WREs are the most common amongst employees. The AFTS Review commented that 'in 2006-07, three quarters of net taxpayers claimed WREs for items including tools of trade, equipment, technical and trade books, travel, self-education and home office costs'.⁷ The AFTS Review stated:
- WRE claims account for around 42 per cent of the value of all deductions claimed by individuals, or around \$14 billion in 2006-07 (ATO 2009). Generally, the claimable amount is not capped, and the total claimed has grown substantially over time.⁸
- 1.12 An examination of the use of deductions for WREs in other countries shows that other comparable countries have limited or no deductions for WREs. The AFTS Review concluded that 'compared to Australia, a number of countries that allow deductions for WREs do so only for a very limited and carefully prescribed set of expenses'.⁹ The following table extracted from the AFTS Review provides an international comparison of deductions for WREs.

5 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 53.

6 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 54.

7 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 53.

8 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 53.

9 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 54.

Table 1.1 International comparisons of deductions for WREs

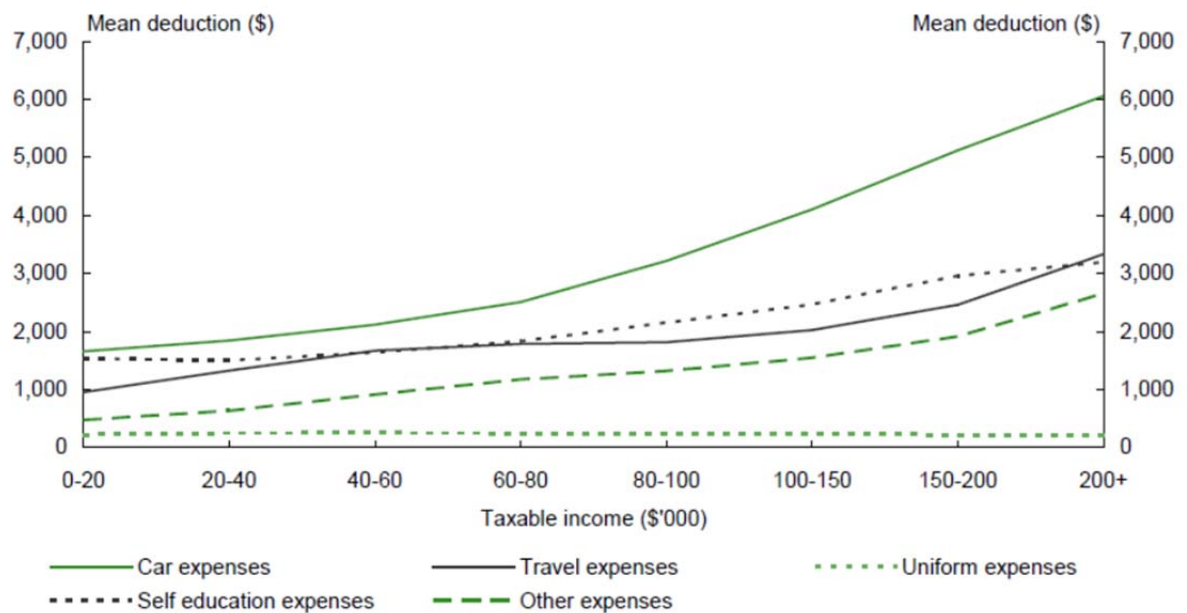
Country	Deductions for work-related expenses	Scope of deductions and arrangements
Australia	Yes	Incurred in gaining or producing an employee's assessable income.
Canada	Limited	Only deductions specifically legislated are allowed, for example, work supplies that you must provide and pay for under your contract of employment.
Denmark	Yes	Wage or salary earners can fully deduct work-related expenses from income, after a standard deduction has been applied.
Ireland	Yes — narrow	Expenses incurred wholly, exclusively and necessarily in the performance of duties.
Japan	Limited	Specific deductions that exceed the standard deduction for employment income are allowed. Specific deductions include travelling expenses.
Netherlands	Yes — narrow	Most work-related expenses are not deductible; in limited circumstances exceptions apply for transport, education and home office expenses.
New Zealand	No	No deductions for work-related expenses for employees.
Spain	No	A general standard deduction for work-related expenses is available, which decreases as income increases.
Switzerland	Limited	Taxpayers are allowed a deduction corresponding to 3 per cent of net income. This deduction may be no less than CHF 2,000 and no more than CHF 4,000.
United Kingdom	Yes — narrow	Most claimable expenses must be incurred wholly, exclusively and necessarily in the performance of an employee's duties, a condition that precludes the deduction of many employment-related expenses.
United States	Limited	Employees can deduct work-related expenses subject to limits (expenses generally only deductible to the extent they exceed 2 per cent of adjusted gross income). Taxpayers have the option of claiming a standard deduction in lieu of itemising deductions.

Source Australian Government, *Australia's Future Tax System, Final Report, Part 2, December 2009, Vol 1, p. 54*; updates to this table have been included from PBO, *Submission 25, p. 15, Table 4: Tax relief for work-related expenses for selected OECD countries*; and Treasury, *Submission 19, p. 5, Table 3: Deductibility of work-related expenses for selected OECD countries*.

1.13 The AFTS Review noted that most WREs including car and self-education expenses increase with income. The AFTS Review observed that 'generally, WRE claims follow income, although uniform expenses remain flat'.¹⁰ Figure 1.1 demonstrates how the value of most WREs increase as taxable income increases.

¹⁰ Australian Government, *Australia's Future Tax System, Final Report, Part 2, December 2009, Vol 1, p. 54*.

Figure 1.1 Mean work-related expense deductions by type, 2006-07



Source Australian Government, *Australia's Future Tax System, Final Report, Part 2, December 2009, Vol 1, p. 55.*

1.14 In contrast, Table 1.2 shows that claims as a percentage of income are higher for lower income earners than for higher income earners. The ATO noted that, as 'the taxable income of individuals increases, the relative proportion of work related expenses to taxable income decreases'.¹¹

11 Australian Taxation Office (ATO), *Response to Questions on Notice, Question 7: Workplace deductions curve*, March 2017, <http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/Taxdeductibility/Documents>.

Table 1.2 Proportion of Work Related Expenses to Taxable Income by Ranges of Taxable Income, 2013-2015

Lower Range taxable income	Upper Range taxable income	Income Year		
		2013	2014	2015
\$1	\$10,000	11.1%	11.3%	12.2%
\$10,001	\$20,000	6.1%	6.2%	6.6%
\$20,001	\$30,000	5.4%	5.5%	5.8%
\$30,001	\$40,000	4.6%	4.7%	5.0%
\$40,001	\$50,000	4.3%	4.4%	4.6%
\$50,001	\$60,000	4.2%	4.3%	4.4%
\$60,001	\$70,000	4.0%	4.1%	4.3%
\$70,001	\$80,000	3.8%	3.9%	3.9%
\$80,001	\$90,000	3.7%	3.7%	3.8%
\$90,001	\$100,000	3.5%	3.6%	3.7%
\$100,001	\$110,000	3.3%	3.4%	3.5%
\$110,001	\$120,000	3.1%	3.2%	3.3%
\$120,001	\$130,000	2.9%	3.0%	3.1%
\$130,001	\$140,000	2.8%	2.8%	2.9%
\$140,001	\$150,000	2.7%	2.7%	2.7%
\$150,001	\$160,000	2.5%	2.6%	2.6%
\$160,001	\$170,000	2.4%	2.5%	2.4%
\$170,001	\$180,000	2.2%	2.2%	2.2%
\$180,001	\$190,000	2.2%	2.3%	2.3%
\$190,001	\$200,000	2.2%	2.3%	2.3%
\$200,001	\$210,000	2.1%	2.2%	2.3%
\$210,001	\$220,000	2.1%	2.2%	2.1%
\$220,001	\$230,000	2.0%	2.1%	2.1%
\$230,001	\$240,000	2.0%	2.0%	2.0%
\$250,000	and over	1.3%	1.3%	1.3%
All Income Ranges		3.6%	3.7%	3.8%

Source Australian Taxation Office (ATO), *Response to Questions on Notice, Question 7: Workplace deductions curve, March 2017* <http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/Taxdeductibility/Documents>.

1.15 The above table suggests that lower income employees rely heavily on claiming legitimate workplace deductions to reduce their taxable income.

1.16 While Australia has an extensive framework of deductions for WREs it is also complex and creates a significant compliance burden for individuals and adds to administration costs for the Australian Taxation Office (ATO). The AFTS Review commented that the law for WREs is complex noting that 'while the general principles are simple, many tax rulings, court rulings and legislative provisions underpin their application'.¹² The AFTS Review stated:

12 Australian Government, *Australia's Future Tax System, Final Report, Part 2, December 2009, Vol 1, p. 55.*

Under the current framework, there are significant difficulties in correctly quantifying work-related costs, in apportioning expenses between income-earning purposes and private purposes, and in defining and claiming the deductions. These complex arrangements constitute one of the impediments to further pre-filing of tax returns and, ultimately, removing the need to complete a tax return for a large number of employees.¹³

- 1.17 A further feature identified by the AFTS Review was the wide variation in the WRE claims among individuals with identical occupations and incomes. This issue was partly explained by taxpayers interpreting expenses differently and some employers paying for a particular expense while others do not. The AFTS Review noted that Canada, which has a similar tax system and administrative arrangements to Australia, estimated that 10 to 15 per cent of WRE claims are invalid. The AFTS Review concluded that if this was a similar order of invalid claims in Australia then this would have amounted to an over claim of between \$1.4 and \$2.1 billion in 2006-07.¹⁴
- 1.18 In conclusion, the AFTS Review made the following three findings in relation to WRE deductions:
- The scope of work-related expenses for which a tax deduction can be claimed is broad by international standards.
 - Deductibility for work-related expenses adds a great deal of complexity to the personal income tax system and imposes high compliance costs on taxpayers.
 - The scope and number of claims significantly limits opportunities for fully automating the preparation of tax returns using pre-filing.¹⁵
- 1.19 The AFTS Review further concluded that the numbers of claims by individuals of the cost of managing tax affairs reflected the system being overly complex.¹⁶ The AFTS Review found that three quarters of the 11.8 million individuals lodging a tax return in 2006-07 used a tax agent. Approximately two thirds of this number, or 5.3 million individuals, claimed a deduction for the cost of managing their tax affairs, totalling

13 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 55.

14 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 55.

15 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 56.

16 The cost of managing tax affairs is deductible to all taxpayers. The AFTS Review noted that the deduction is important in recognising the compliance costs imposed by government on individuals and is one of the direct costs of the tax system.

over \$1.4 billion. The average deduction for these expenses was \$206 for employees and \$740 for investors.¹⁷

- 1.20 As a result of the findings, the AFTS Review recommended the introduction of a standard deduction for work-related expenses and the cost of managing tax affairs to simplify personal tax for most taxpayers. It also recommended allowing taxpayers a choice between a standard deduction or claiming actual expenses where they are above the claims threshold, with full substantiation.¹⁸
- 1.21 The AFTS Review acknowledged the role of the deductibility of self-education expenses to encourage further education and training, recommending that tuition fees for education related to current employment should be excluded from the standard deduction (whilst other deductible self-education expenses would be included in the standard deduction) and should be deductible from the first dollar, with full substantiation.¹⁹
- 1.22 The AFTS Review also recommended a tighter nexus between the deductibility of the expense and its role in producing income to improve clarity for taxpayers and ensure that WREs and other deductions are well-targeted.²⁰

Interest deductibility in company income tax

- 1.23 In relation to the company income tax rate, the AFTS Review recommended that it should be reduced to 25 per cent over the short to medium term with the timing subject to economic and fiscal circumstances. The AFTS Review stated:
- Australia reduced its company tax rate over the period from the late 1980s to 2000. This adjustment was an important element of policy reforms that have led to strong growth. A continuation of this responsive adjustment would underpin further growth.²¹
- 1.24 The AFTS Review found that in 2009 Australia's company tax rate of 30 per cent was high and was around 5 percentage points higher than the

17 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 56.

18 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 57.

19 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 59.

20 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 57.

21 Australian Government, *Australia's Future Tax System, Final Report, Part 1, Overview*, December 2009, p. 8.

average for small to medium sized Organisation for Economic Co-operation and Development (OECD) countries.²²

1.25 The AFTS Review noted the lower corporate tax rates in other OECD countries and stated:

Australia should respond to these developments by reducing the company income tax rate to 25 per cent over the short to medium term, as fiscal and economic circumstances permit. This would ensure that Australia remains an attractive place to invest - not only in the resources sector but also in the non-resource sectors of the economy.²³

1.26 In reviewing the future of business taxation, the AFTS Review considered a number of options for fundamental reform, one of which was the comprehensive business income tax model, which taxes the full return to capital (debt and equity), albeit at a possibly low marginal rate. This is in comparison to the existing company income tax which is essentially a source-based tax on the full nominal return to equity.²⁴

1.27 The AFTS Review noted that the comprehensive business income tax is based on an income tax system, but with the difference that interest expenses would no longer be deductible. The broadening of the tax base could facilitate a reduction in the company income tax rate, but this would reduce its effectiveness as a backstop to the personal income tax system. As a significant amount of debt is currently untaxed, this option would also increase the cost of debt financed investment. There would also be significant transitional issues for highly leveraged businesses.²⁵

1.28 After considering a number of options, the AFTS Review recommended that the structure of the company income tax system should be retained in its present form, at least in the short to medium term, noting that replacing the current income tax system with an alternative could involve considerable risks.²⁶

22 Australian Government, *Australia's Future Tax System, Final Report, Part 1, Overview*, December 2009, p. 39.

23 Australian Government, *Australia's Future Tax System, Final Report, Part 1, Overview*, December 2009, p. 40.

24 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 164.

25 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 164.

26 Australian Government, *Australia's Future Tax System, Final Report, Part 2*, December 2009, Vol 1, p. 165.

Business Tax Working Group – November 2012

Interest deductibility in company income tax

- 1.29 The Business Tax Working Group (BTWG) was asked by government to prioritise consideration of a cut to the company tax rate accompanied by measures that fully offset the cost.²⁷
- 1.30 The BTWG reemphasised the views made by the AFTS Review that a lower company tax rate could lead to increased investment in Australia which could contribute to improved productivity and higher incomes for Australians. The BTWG stated:
- Australia is a relatively small, somewhat open economy that is increasingly integrated with international capital markets and reliant on highly mobile international capital to fund new investment. In this context, a lower statutory corporate tax rate would increase Australia's ability to attract foreign investment and increase the quality of the capital stock for greater productivity. Over time, it would generally be expected that the economic benefits of greater productivity will be distributed between capital owners, labour and consumers, through higher profits and real wages and through lower prices.²⁸
- 1.31 The BTWG's terms of reference stipulated that in order to pursue the economic benefits associated with a reduction in the company tax rate, 'savings should be identified from within the business tax system in order to progress reforms in a cost neutral way'.²⁹ The BTWG noted:
- It is inevitable that a company tax rate cut funded through measures that broaden the corporate tax base will generally involve a redistribution from those who benefit from existing concessions to the broader corporate taxpaying base, at least in the short term. It is often easier to identify those who stand to lose from base broadening measures, compared to those who stand to gain (perhaps marginally) by a lower corporate tax rate.
- While base broadening measures can in theory be tailored to provide a smoothed withdrawal of a concession or staged introduction of new rules, this has implications for the size of the rate cut that can be afforded and how soon it could be introduced.³⁰

27 Business Tax Working Group, *Final Report*, November 2012, p. ii.

28 Business Tax Working Group, *Final Report*, November 2012, p. ii.

29 Business Tax Working Group, *Discussion Paper*, August 2012, p. 3.

30 Business Tax Working Group, *Discussion Paper*, August 2012, p. 15.

- 1.32 The BTWG canvassed base broadening options in the areas of interest deductibility, capital allowance and research and development expenditure 'which, if adopted, could fund a company tax rate cut of two to three percentage points'.³¹
- 1.33 The BTWG found it was difficult to identify support for measures that would further broaden the business tax base and there was a lack of agreement in the business community on measures to fund a cut in the company tax rate by broadening the business tax base. One of the factors leading to this conclusion included the reductions in the company tax rate during the 1980s and 1990s being paid for by broadening the business tax base. In addition, the BTWG commented that 'the economic benefits from a reduction in the company tax rate from the current rate are likely to be smaller than when the rate was much higher in the 1980s and 1990s, notwithstanding that capital may have become more mobile since then'.³² The BTWG concluded:
- These factors have underpinned the lack of support in the business community for pursuing a lower rate/broader base reform of business taxation in Australia at this time. Many businesses that were particularly affected by the base broadening options asserted that they would have been worse off under the trade-offs canvassed. Further, some submissions questioned whether there would be a net benefit for the economy as a whole from a combination of some of the base broadening measures canvassed and a cut in the company tax rate of between one and three percentage points.³³
- 1.34 Notwithstanding this conclusion, the BTWG stated that 'there are benefits from a lower company tax rate and therefore Australia should have an ambition to continue the trend from the late 1980s to reduce its company tax rate as economic and fiscal circumstances and other budget priorities permit'.³⁴

Re: think Tax Discussion Paper – March 2015

- 1.35 The former Treasurer released the *Re: think* Tax Discussion Paper (*Re: think*) on 30 March 2015 and called for submissions.³⁵

31 Business Tax Working Group, *Final Report*, November 2012, p. ii.

32 Business Tax Working Group, *Final Report*, November 2012, p. iii.

33 Business Tax Working Group, *Final Report*, November 2012, p. iii.

34 Business Tax Working Group, *Final Report*, November 2012, p. iii.

35 The *Re:think* website states that: 'although the period for formal submissions has closed the Government will continue to receive input and engage with the community on how we can

Work-related expense deductions for individuals

- 1.36 Australia's income tax schedule for individuals is progressive, with a high tax-free threshold followed by increasing tax rates at subsequent thresholds. The rate specified at each tax bracket is the 'marginal' tax rate, which is the amount of tax payable on a taxpayer's next dollar of taxable income, not the 'average' tax rate on that person's entire taxable income.³⁶ The following table outlines the marginal rates and thresholds for 2014-15.

Table 1.3 Schedule of marginal rates and thresholds, 2016-17

Taxable Income`	Tax on This Income (New Rates)
0 to \$18,200	Nil
\$18,201 to \$37,000	19c for each \$1 over \$18,200
\$37,001 to \$87,000*	\$3,572 plus 32.5c for each \$1 over \$37,000
* \$87,001 to \$180,000	\$19,822 plus 37c for each \$1 over \$87,000
\$180,001 and over	\$54,232 plus 47c for each \$1 over \$180,000

Source ATO, *Individual income tax rates, July 2016*, <<https://www.ato.gov.au/rates/individual-income-tax-rates/>>, viewed 30/5/2017.

- 1.37 *Re: think* noted that the imposition of tax on individuals can adversely affect behaviour, such as how much, and where, they work and earn. It was suggested that some people respond to increasing marginal tax rates as the distribution of taxpayers across the taxable income scale clusters around the tax thresholds.³⁷ As noted in the AFTS Review, *Re: think* reinforced that high effective marginal tax rates (including through the interaction with the transfer system) can deter workforce participation or lead to tax planning activities as individuals seek to reduce their tax burden.³⁸
- 1.38 In Australia, individuals are able to claim a broad range of WREs against their assessable income as long as they are used for work. In 2011-12, around 8.5 million people claimed WREs totalling nearly \$19.4 billion, although around 38 per cent of tax filers had claims of less than \$500.³⁹
- 1.39 Australia's tax system is relatively generous in respect of WRE claims compared to some other countries. For example, the United Kingdom limits deductions to those that are incurred wholly, exclusively and necessarily in the performance of an employee's duties, although the compliance burden associated with substantiating deductions remains. In

achieve a better tax system.' See: Australian Government, *Re: think – Better tax, better Australia*, <<http://bettertax.gov.au/the-conversation/so-far/>>, viewed 16/5/2017.

36 Australian Government, *Re: think Tax Discussion Paper*, March 2015, p. 36.

37 Australian Government, *Re: think Tax Discussion Paper*, March 2015, p. 41.

38 Australian Government, *Re: think Tax Discussion Paper*, March 2015, p. 7.

39 Australian Government, *Re: think Tax Discussion Paper*, March 2015, p. 54.

comparison, New Zealand ‘cashed out’ WRE deductions in the late 1980s by providing income tax cuts in exchange for disallowing WRE deductions. This has been a major driver of compliance savings by reducing the number of people needing to file a tax return – in the 2012 tax year around 1.25 million individual tax returns were filed in New Zealand out of an estimated 3.3 million individual tax payers.⁴⁰

- 1.40 Despite the compliance burden associated with WRE deductions, *Re: think* stated that tightening the arrangements for WRE deductions in Australia would require careful consideration of how to manage legitimate expenses incurred by employees. It suggested that in some cases, the expense could be met by an employer providing the necessary item (for example, uniforms or protective equipment), and then having the item returned if the employee leaves. Other cases may be less straightforward, such as self-education expenses where the benefit is embodied in the employee’s human capital.⁴¹
- 1.41 In relation to self-education expenses, *Re: think* discussed that existing arrangements could be somewhat restrictive, particularly when structural change in the economy increases the importance of re-training to meet ever-changing labour demand needs. Under current arrangements, self-education expenses may only legitimately be claimed if the individual maintains or improves the specific skills or knowledge required in the individual’s current employment. Someone working in one occupation, who is seeking to retrain or reskill so that they can transition to another occupation, generally cannot deduct that expenditure. However, any loosening of the eligibility could lead to problems with compliance.⁴²
- 1.42 *Re: think* noted that in the past, Australia has considered a ‘standard deduction’ on WREs to reduce compliance burden and allow greater use of pre-filled income tax returns.⁴³ To obtain compliance savings, *Re: think* similarly suggested that taxpayers incurring a relatively low value of WREs could choose to ‘tick a box’ to claim a standard deduction at a set amount (for example, \$500). *Re: think* observed however that despite the simplicity benefit, a standard deduction would come at significant cost as individuals not currently incurring WRE deductions could reduce their taxable income by the value of the standard deduction.⁴⁴

40 Australian Government, *Re: think Tax Discussion Paper*, March 2015, p. 54.

41 Australian Government, *Re: think Tax Discussion Paper*, March 2015, p. 55.

42 Australian Government, *Re: think Tax Discussion Paper*, March 2015, p. 55.

43 Australian Government, *Re: think Tax Discussion Paper*, March 2015, p. 54.

44 Australian Government, *Re: think Tax Discussion Paper*, March 2015, p. 55.

- 1.43 In other words, while a standard deduction may simplify arrangements and result in compliance savings, the end result could be a higher net cost to the budget.
- 1.44 *Re: think* suggested the extent of tax advice currently relied upon as evidence that the personal income tax system is overly complex. The time and resources spent on managing tax affairs rose significantly from 1998-99 to 2009-10, which could reflect the increasing complexity associated with the accumulation of changes to the tax system over time. The cost of managing tax affairs for individual tax filers appears to have levelled off since 2009-10, which could reflect the impact of technology on the taxpayer experience. While the underlying complexity of the system may have increased in this time, ATO use of electronic tools (such as pre-filled tax returns) has improved the taxpayer experience.⁴⁵
- 1.45 *Re: think* further discussed the impact of increasing complexity in the tax system. Unintended incentives or disincentives in the tax system can be created, resulting in taxpayers who can afford it to more likely seek expert assistance to manage their tax affairs. Complexity can also make the tax system less transparent, which can adversely affect voluntary compliance. In addition, a more complex tax system is more expensive to administer, increasing the resources required by the ATO.⁴⁶

Interest deductibility in company income tax

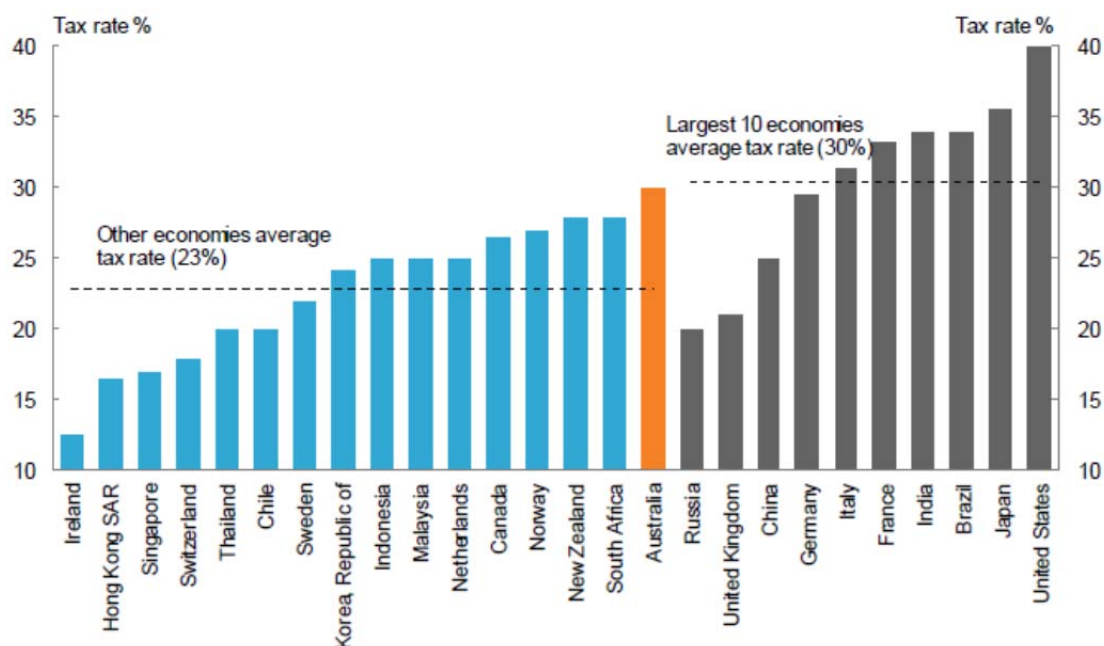
- 1.46 Prior to recent reductions in the small business tax rate all Australian companies were levied at 30 percent. *Re: think* reported in 2015 that Australia's corporate tax rate is higher than many countries that Australia competes with for investment.⁴⁷ *Re: think* compared corporate tax rates for selected trading partners for 2014. These rates are shown in Figure 1.2.

45 Australian Government, *Re: think Tax Discussion Paper*, March 2015, p. 169.

46 Australian Government, *Re: think Tax Discussion Paper*, March 2015, pp. 170-71.

47 Australian Government, *Re: think Tax Discussion Paper*, March 2015, p. 74.

Figure 1.2 Corporate tax rates, selected trading partners, 2014



Source Australian Government, *Re: think – Tax Discussion Paper*, March 2015, p. 75.

1.47 *Re: think* stated that reducing Australia's corporate tax rate would encourage higher levels of investment in Australia and lead to capital deepening, promoting economic growth. Whilst tax is one of many factors that affect Australia's appeal as a destination for foreign investment, tax can have a significant impact on investment decisions. *Re: think* provided the following explanation:

Corporate tax applies to the profits of companies, reducing the return from their investments. This reduces the level of investment in small, open, capital importing economies, such as Australia. This is because the marginal investor in Australia is likely to be a non-resident, who will invest in business opportunities in Australia only if they achieve an after-tax return that matches their target rate of return ...

In the near term, lower taxes would provide an increased incentive for non-residents to invest in Australia. In the long run, increased investment would benefit all Australians.⁴⁸

1.48 *Re: think* also noted other additional factors that need to be taken into account in considering a reduction in the company tax rate. These include:

- a reduced incentive for tax planning and profit shifting from Australia for multinational companies;

48 Australian Government, *Re:think Tax Discussion Paper*, March 2015, p. 78.

- exacerbation of the disparity between the corporate tax rate and the highest marginal tax rate in the personal tax system;
 - a significant impact on tax revenue in the short term;
 - existing investments receiving the benefit of the reduced corporate tax rate; and
 - a reduction of the tax paid by investments that would have taken place under the former tax rate.⁴⁹
- 1.49 In considering interest deductibility in the company income tax system, *Re: think* affirmed the robustness of Australia's integrity measures around this area. It outlined recent reforms including the tightening of Australia's thin capitalisation rules to stop multinationals claiming excessive debt deductions⁵⁰ and the strengthening of Australia's transfer pricing rules to bring them into closer alignment with international best practice.⁵¹
- 1.50 In addition, *Re: think* noted other measures to prevent abuse of the current system, including an extensive general anti-avoidance rule to capture arrangements designed to avoid paying Australian tax, controlled foreign company rules to prevent Australian companies shifting income offshore and the ATO's compliance programs specifically addressing global tax structuring arrangements by multinational companies.⁵²

Australian tax deductions

What is a tax deduction?

- 1.51 The Australian income tax system approximates a comprehensive income tax base and generally provides a full deduction for expenses and losses incurred in gaining tax assessable income. A fully comprehensive income tax base would tax the net economic gain, adjusted for inflation derived in a period of time. This means an individual would be taxed on consumption plus the change in their net wealth for a period, which necessarily allows for all expenses incurred in the earning of that income or wealth to be deducted.⁵³
- 1.52 In practice, income tax systems in most countries, including Australia, exhibit significant departures from a comprehensive income tax base. This can be for a range of reasons, including providing assistance to particular

49 Australian Government, *Re:think Tax Discussion Paper*, March 2015, pp. 80-81.

50 Australian Government, *Re:think Tax Discussion Paper*, March 2015, p. 82.

51 Australian Government, *Re:think Tax Discussion Paper*, March 2015, p. 94.

52 Australian Government, *Re:think Tax Discussion Paper*, March 2015, p. 82.

53 Treasury, *Submission 19*, p. 2.

groups of taxpayers and supporting specific economic activities, and for ease of administration.⁵⁴

- 1.53 The most relevant definition for Australian tax purposes of a deduction occurs in section 8-1 of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) which states:
- You can deduct from your assessable income any loss or outgoing to the extent that:
 - ⇒ it is incurred in gaining or producing your assessable income; or
 - ⇒ it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.
 - However, you cannot deduct a loss or outgoing to the extent that it is capital, private or domestic in nature.
- 1.54 The Commissioner of Taxation has provided additional guidance on the meaning of the term 'incurred' in the above legislation as follows:
- As a broad guide, you incur an outgoing at the time you owe a present money debt that you cannot escape. But this broad guide must be read subject to the propositions developed by the courts.⁵⁵
- 1.55 Section 8-5 of the ITAA 1997 also provides for specific deductions (which are not covered under section 8-1) which can be deducted from a taxpayer's assessable income. The list of deductions is provided in section 12-5 of the ITAA 1997.

Personal tax deductions

- 1.56 In Australia, for individuals these deductions may include work-related expenses as well as non-work-related expenses. Work-related expenses usually fall within the general provision for deductions (section 8-1 of the ITAA 1997), although there are some exceptions.
- 1.57 Examples of work-related expenses can include:
- car expenses, including fuel costs and maintenance;
 - travel costs;
 - clothing expenses;
 - self-education expenses;
 - home computer and phone expenses;
 - tools and equipment expenses;

54 Treasury, *Submission 19*, p. 2.

55 Australian Government, ATO, *Taxation Ruling Income tax: section 8-1 - meaning of 'incurred' - timing of deductions*, TR 97/7, 30 April 1997.

- journals and trade magazines; and
- union fees.⁵⁶

1.58 Examples of non-work-related expenses include:

- expenses incurred in earning interest and dividend income;
- deductions for gifts and donations; and
- deductions for the cost of managing tax affairs.⁵⁷

Business tax deductions

1.59 Business tax deductions are more complex. A general list sourced from the 2015 Australian Master Tax Guide is shown at Appendix C.

Tax deductions – number and value 2010-11 to 2012-13

1.60 The following table shows the number and value of **personal** income tax deductions for 2010-11 to 2012-13 from published Taxation Statistics:

Table 1.4 Individuals – selected deductions, 2010–11 to 2012–13 income years

	2010–11		2011–12		2012–13	
	no.	\$m	no.	\$m	no.	\$m
Work-related expenses	8,333,960	18,270	8,549,065	19,358	8,514,345	19,761
Personal superannuation contributions	188,615	4,233	185,860	4,400	183,975	2,909
Cost of managing tax affairs	5,930,500	2,125	6,128,240	2,276	6,201,835	2,351
Gifts or donations	4,793,775	2,212	4,536,370	2,242	4,548,810	2,293
Other deductions	646,295	1,560	678,725	1,458	675,210	1,688
Dividends deductions	301,600	1,577	285,095	1,394	268,670	1,212
Interest deductions	481,785	1,299	437,125	1,144	370,655	917
Other deduction labels		242		445		253
Total deductions/numbers	20,676,530	31,520	20,800,480	32,718	20,763,500	31,384

Source ATO, *Taxation Statistics 2012-13, Table 10: Individuals – selected deductions, 2010–11 to 2012–13 income years, May 2015.*

56 ATO, *Deductions you can claim*, 27 August 2015, <<https://www.ato.gov.au/Individuals/Income-and-deductions/Deductions-you-can-claim/>>, accessed 26 February 2016.

57 ATO, *Deductions you can claim*, 27 August 2015, <<https://www.ato.gov.au/Individuals/Income-and-deductions/Deductions-you-can-claim/>>, accessed 26 February 2016.

1.61 The following table shows the general categories of deductions and their percentages of the above totals:

Table 1.5 Individuals - Selected Deductions - % shares of totals

	2010–11		2011–12		2012–13	
	no.	\$m	no.	\$m	no.	\$m
Work-related expenses	40.3%	58.0%	41.1%	59.2%	41.0%	63.0%
Personal superannuation contributions	0.9%	13.4%	0.9%	13.4%	0.9%	9.3%
Cost of managing tax affairs	28.7%	6.7%	29.5%	7.0%	29.9%	7.5%
Gifts or donations	23.2%	7.0%	21.8%	6.9%	21.9%	7.3%
Other deductions	3.1%	4.9%	3.3%	4.5%	3.3%	5.4%
Dividends deductions	1.5%	5.0%	1.4%	4.3%	1.3%	3.9%
Interest deductions	2.3%	4.1%	2.1%	3.5%	1.8%	2.9%
Other deduction labels		0.8%		1.4%		0.8%

Source *Taxation Statistics, Calculations by Parliamentary Library.*

1.62 The following table shows both the value and number of **business** deductions from 2010-11 to 2012-13:

Table 1.6 Companies – selected expenses, 2010–11 to 2012–13 income years

	2010–11		2011–12		2012–13	
	no.	\$m	no.	\$m	no.	\$m
Cost of sales	246,685	1,030,367	255,575	1,091,057	268,940	1,158,573
All other expenses	?	666,200	?	716,634	?	749,432
Interest expenses within Australia	296,010	150,535	304,095	154,900	318,545	131,047
Contractor, subcontractor and commission expenses	152,175	86,017	157,250	96,016	162,640	101,131
Depreciation expenses	451,600	66,271	463,385	70,501	476,325	81,392
Expenses from financial arrangements (TOFA)	275	15,214	680	19,187	995	61,319
Rent expenses	233,195	42,690	242,905	42,415	255,920	45,991
Interest expenses overseas	9,720	31,221	10,395	31,836	4,490	32,942
Superannuation expenses	325,515	27,234	334,560	29,257	348,130	29,474
Repairs and maintenance	277,805	20,063	283,015	21,796	291,885	22,732
Unrealised losses on revaluation of assets to fair value	2,255	18,380	2,595	19,323	2,210	20,800
Motor vehicle expenses	345,185	11,943	355,865	12,412	371,880	12,973
Royalty expenses within Australia	5,835	11,475	6,135	12,601	6,235	12,039
Other expense items	na	32,339	na	26,446	na	25,939
Total expenses/numbers	2,099,570	2,201,100	2,416,455	2,344,380	2,508,195	2,485,784

Source *Taxations Statistics with Parliamentary Library adjustments. ATO, Taxation Statistics 2012-13, Table 19: Companies – selected expenses, 2010–11 to 2012–13 income years, May 2015. Some of the data appeared to be unreliable and was deleted. Some totals were recalculated by the Parliamentary Library.*

1.63 The following table shows the significant business tax deductions, by percentage of total value for various years:

Table 1.7 Companies – selected expenses, 2010–11 to 2012–13 income years, % of totals

	2010–11		2011–12		2012–13	
	no.	\$m	no.	\$m	no.	\$m
Cost of sales	11.7%	46.8%	10.6%	46.5%	10.7%	46.6%
All other expenses	?	30.3%	?	31%	?	30%
Interest expenses within Australia	14.1%	6.8%	12.6%	6.6%	12.7%	5.3%
Contractor, subcontractor and commission expenses	7%	4%	7%	4%	6%	4%
Depreciation expenses	21.5%	3.0%	19.2%	3.0%	19.0%	3.3%
Expenses from financial arrangements (TOFA)	0.01%	0.69%	0.03%	0.82%	0.04%	2.47%
Rent expenses	11.1%	1.9%	10.1%	1.8%	10.2%	1.9%
Interest expenses overseas	0.5%	1.4%	0.4%	1.4%	0.2%	1.3%
Superannuation expenses	15.5%	1.2%	13.8%	1.2%	13.9%	1.2%
Repairs and maintenance	13.2%	0.9%	11.7%	0.9%	11.6%	0.9%
Unrealised losses on revaluation of assets to fair value	0.1%	0.8%	0.1%	0.8%	0.1%	0.8%
Motor vehicle expenses	16.4%	0.5%	14.7%	0.5%	14.8%	0.5%
Royalty expenses within Australia	0.3%	0.5%	0.3%	0.5%	0.2%	0.5%
Other expense items	na	1.5%	na	1.1%	na	1.0%

Source ATO, *Taxation Statistics 2012-13, Table 19: Companies – selected expenses, 2010–11 to 2012–13 income years, May 2015. Calculations provided by Parliamentary Library.*

1.64 The Parliamentary Library in preparing the above table noted that ‘although comparatively frequently claimed, interest expenses were a small part of the overall amount of business deductions in the years above’.

Objectives, scope and focus of the inquiry

1.65 The focus of the review was the consideration of options to broaden the base of both personal and company tax through changes to deductions for the purpose of funding reductions in marginal tax rates.

1.66 While it was noted that in 2012, the Business Tax Working Group examined options to broaden the company tax base through changes to deductions, the committee considered that it was timely to review certain personal and company tax deductions.

1.67 In particular, the committee’s review focused on work-related expenses and interest deductibility.

Personal income tax deductions

- 2.1 In the Australian tax system, individuals can reduce their taxable income (and as a result the amount of tax payable) by claiming deductions, which are generally provided for under section 8-1 of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997). This general deduction provision allows deductions for 'expenses that individuals incur in gaining their personal non-business income (for example, salary and wages, rent, interest or net capital gains from investments), other than expenses that are capital, private or domestic in nature'.¹ Under the general deduction provision, expenses usually fall into two categories: work-related expenses (WREs) or investment-related expenses.²
- 2.2 There are also specific deductions³ that are not directly related to earning personal income. These include the cost of managing tax affairs, deductible gifts and donations, union fees and subscriptions to trade, business or professional associations, and a car expenses valuation method.⁴

Overview and major themes

- 2.3 Taxable income is assessable income minus deductions. Consequently, tax deductions have negative revenue implications for government as deductions reduce taxpayers' taxable income, with the impact on tax revenue 'equal to the combined total of the reduction in taxable income for each affected taxpayer multiplied by their respective effective marginal tax

1 Treasury, *Submission 19*, p. 3.

2 Treasury, *Submission 19*, p. 3.

3 Set out under section 12-5 of the ITAA 1997.

4 Treasury, *Submission 19*, p. 4.

rate'.⁵ For the 2012-13 financial year,⁶ more than 80 per cent of Australian taxpayers claimed some form of personal deduction, totalling \$31.3 billion claimed, or around 4.5 per cent of the year's taxable income (\$704 billion). The mean deduction claimed for that year was approximately \$3 025.⁷

- 2.4 Individuals' income tax is the single largest Australian Government revenue source and has consistently raised around half of the Australian Government's tax receipts since the 1970s.⁸ Australian Bureau of Statistics figures quoted by Ernst and Young indicated that in 2013-14, personal income tax accounted for 47.2 per cent of the \$352 billion in tax revenue raised that year.⁹
- 2.5 The submission from the Parliamentary Budget Office (PBO) indicated that in 2012-13, WREs were the most common personal tax deduction (approximately 63 per cent of the value of total deductions), followed by personal superannuation contributions (9.3 per cent of all deductions), then expenses incurred in managing tax affairs (7.5 per cent), and deductions for charitable gifts and donations (7.3 per cent).¹⁰
- 2.6 A selection of deductions from the 2010-11 to 2012-13 financial years is set out in Table 2.1, similarly indicating that a significant proportion of deductions claimed are WREs.

5 Parliamentary Budget Office (PBO), *Submission 25*, p. 3.

6 The PBO advised that 2012-13 data is the most recent comprehensive data available on tax deductions given the lag in reporting due to the timing of personal income tax collections. PBO, *Submission 25*, p. 7.

7 PBO, *Submission 25*, p. 7.

8 Australian Government, *Re: think Tax Discussion Paper*, March 2015, p. 39.

9 Ernst and Young, *Submission 12*, p. 11, Appendix 2.

10 PBO, *Submission 25*, pp. 9-10.

Table 2.1 Individuals – selected deductions, 2010-11 to 2012-13 income years

Individual Deductions	2010-11		2011-12		2012-13	
	no.	\$m	no.	\$m	no.	\$m
Work-related expenses	8,333,960	18,270	8,549,065	19,358	8,514,345	19,761
Cost of managing tax affairs	5,930,500	2,125	6,128,24	2,276	6,201,835	2,351
Gifts or donations	4,793,775	2,212	4,536,370	2,242	4,548,810	2,293
Interest deductions ^(a)	481,785	1,299	437,125	1,144	370,655	917
Total Deductions^(b)	N/A	27,285	N/A	28,317	N/A	28,475

Source Treasury, Submission 19, p. 5, Table 2: Individuals – selected deductions, 2010-11 to 2012-13 income years.

- (a) Interest deductions relate to expenses incurred in producing interest income, and may include investment management fees or bank account fees. This does not include rental interest deductions.
- (b) Components do not add to the total number of taxpayers claiming deductions because some may claim more than one type of deduction.

2.7 While raising revenue to fund government activities is the primary function of taxation, 'an additional function of the tax system is to encourage individuals and companies to engage in particular behaviours (and to discourage others)'.¹¹ For example, by using superannuation concessions to encourage people to save for retirement, or making donations to eligible not-for-profit organisations that may be providing needed community services tax deductible.¹²

2.8 Tax deductions related to WREs, as the most commonly claimed deductions by individuals, can encourage certain forms of behaviour, with notable examples being expenditure on self-education, membership of certain professional associations or unions, or purchasing protective items or relevant work equipment.

11 Research Australia, Submission 1, p. 4.

12 Research Australia, Submission 1, p. 4.

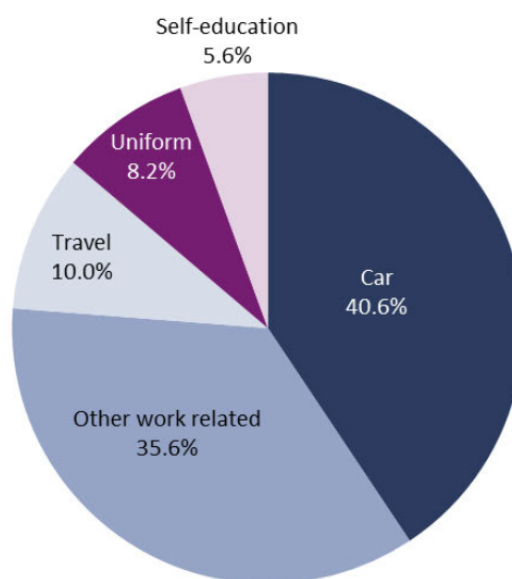
Deductions for work-related expenses

2.9 WREs are the deductions most commonly claimed by individuals. In 2014-15, there were \$21.8 billion in WRE deductions claimed, comprising almost two-thirds of total deductions. The average claim was \$2,000 for people who prepared their own tax return in 2015 and \$2,600 for those who lodged through an agent.¹³

2.10 Under the Australian tax system, individuals can claim a broad range of WREs. As illustrated in Figure 2.1, the PBO submitted that for 2012-13:

The most common type of WRE was car expenses (\$8.0 billion or around 40 per cent of WREs), followed by other WREs (comprising home office costs and tools, equipment and other assets) of around \$7.0 billion, work-related travel expenses (\$2.0 billion), uniform costs (\$1.6 billion) and work-related self-education costs (\$1.1 billion).¹⁴

Figure 2.1 WRE deductions claimed by type in 2012-13



Source PBO, Submission 25, p. 11, Figure 4: Total claimed WRE deductions by type, 2012-13.

2.11 Furthermore, within the WREs category:

The average value of deductions claimed per taxpayer increased with taxable income for all WREs types, with the exception of

13 ATO, Submission 1 (45th Parliament), p. 4.

14 PBO, Submission 25, p. 3.

self-education and uniform expenses, which remained relatively flat across the income distribution.¹⁵

- 2.12 Individuals can claim WRE deductions where they have spent the money and it is related to their employment. Individuals are also required to document and retain for five years proof of claims totalling over \$300.¹⁶
- 2.13 For expenses that involve both work and personal components, the expense is apportioned and only the work component of the expenses is claimable.¹⁷
- 2.14 The Australian Chamber of Commerce and Industry (ACCI) observed that while the theory behind WREs is 'relatively uncontroversial', in practice 'it is hard to make sure that only legitimate deductions are claimed'.¹⁸ Similarly, the Treasury noted that there are complex requirements around WRE deductions, which create uncertainty for taxpayers:

While the general principles underlying deductibility for WREs are simple, they are underpinned by various legal and administrative rulings and decisions. There are difficulties in correctly characterising and apportioning expenses between income-earning purposes and private purposes, and in defining and claiming deductions for WREs...¹⁹

Deductions for cost of managing tax affairs and donations

- 2.15 In addition to income tax deductions under the general provision (in particular many WREs), provision is also made for specific deductions that do not directly relate to earning personal income.²⁰ As illustrated in Table 2.1, deductions for the cost of managing tax affairs and for donations or gifts to charitable organisations comprised \$2 351 million and \$2 293 million, respectively, in 2012-13. This represented 7.5 and 7.3 per cent of total deductions, respectively.²¹
- 2.16 As discussed above, it is suggested that the considerable compliance burden in Australia's complicated tax system has led to a significant

15 PBO, *Submission 25*, p. 12.

16 Treasury, *Submission 19*, p. 8. CPA Australia noted that the \$300 was the 1987 amount, which has never been indexed. Mr Paul Drum, Head of Policy, CPA Australia, *Committee Hansard*, Canberra, 5 February 2016, p. 22.

17 Treasury, *Submission 19*, p. 3.

18 Australian Chamber of Commerce and Industry (ACCI), *Submission 15*, p. [2].

19 Treasury, *Submission 19*, p. 8.

20 Treasury, *Submission 19*, p. 4.

21 PBO, *Submission 25*, p. 3.

number of taxpayers using tax agents to assist in the management of their tax affairs and preparation of tax returns. In 2012-13, 73.5 per cent of Australians lodged their tax return through a tax agent.²² The Treasury advised this was 'one of the highest rates of tax agent usage' in the Organisation for Economic Co-operation and Development (OECD).²³ Chartered Accountants Australia and New Zealand (Chartered Accountants ANZ) observed that:

From a tax practitioner perspective, individual clients have varied reasons for engaging the services of a tax agent but it is undoubtedly true that one of those reasons is that clients trust their tax agent to identify and claim all the deductions and tax offsets to which they are legally entitled.²⁴

2.17 In discussing Australians' relatively high usage of tax agents, Mr Richard Highfield observed that the data suggested that this is growing, notwithstanding 'stated policy directions and some related initiatives intended to simplify the compliance burden'.²⁵

2.18 Deductions on donations to deductible gift recipients (DGRs) is an area in which the principle of deductions to support a certain type of behaviour or 'public good' can be seen:

Donations to such organisations are deductible not because the donations are an expense incurred in earning income but because the Government is keen to encourage individuals and corporations to provide financial support for the activities of these organisations.²⁶

2.19 Many organisations that have DGR status are operating in areas where governments provide or fund services, and so deductibility is effectively a less direct means of support to fund these services. Research Australia asserted that the removal of deductions for donations is likely to reduce the amount of funds to these organisations, which:

...would not only restrict the ability of [not-for-profit] organisations to [provide] services but would also place pressure on the Commonwealth Government to provide additional funding to these organisations to address the shortfall. This is an adverse consequence that is not ameliorated by the simple arithmetic of

22 PBO, *Submission 25*, p. 10.

23 Treasury, *Submission 19*, p. 8.

24 Chartered Accountants ANZ, *Submission 11*, p. 8.

25 Mr Richard Highfield, *Submission 20*, Attachment 1, p. [12].

26 Research Australia, *Submission 1*, p. 7.

lowering the tax rate to compensate for the removal of the tax deduction.²⁷

2.20 In contrast, ADJ Consultancy Services suggested that there was a case against governments using tax simply to subsidise activity, in particular giving money to non-government organisations, and argued that by '[s]topping this constant flow of funds (or at least slowing it down) would give government the means to broaden the income tax base, without undue negative impacts on the economy'.²⁸ The Australian Council of Social Service (ACOSS) also questioned the effectiveness of some tax concessions, but stressed that any changes must be made as part of wider reform to help ameliorate potential negative impacts so reforms do not leave community services worse off.²⁹

2.21 Some form of tax relief for donations is common amongst OECD countries, providing either a deduction to the individual at their effective marginal tax rate, or providing a tax credit at a fixed proportion of the amount donated. However, the PBO noted that in practice there are considerable differences between the rules and requirements in different countries:

For example, the United Kingdom offers assistance through the 'Gift Aid' program. The value of this rebate is equivalent to a tax deduction, but the first 20 pence per pound of donation (equivalent to the marginal tax rate for most individuals) is payable to the charity rather than the individual.³⁰

Concerns about current arrangements

2.22 The majority of submissions supported retaining personal tax deductions, in particular WRE deductions. A number of submitters acknowledged that there are challenges under the current arrangements; these include:

- the significant compliance burden when claiming deductions, particularly WREs;
- the rising level of total personal deductions and concerns that taxpayers may be claiming deductions to which they not entitled (over-claiming); and
- that the deductions are unfairly benefiting some individuals or groups.

27 Research Australia, *Submission 1*, p. 7.

28 ADJ Consultancy Services, *Submission 2*, p. 16.

29 ACOSS, *Submission 24*, p. 3.

30 PBO, *Submission 25*, pp. 13-14.

Compliance burden

2.23 A number of submitters noted that the current system of WRE deductions involves a significant compliance burden, with considerable administrative requirements both for individuals and the Australian Taxation Office (ATO). For example, the Treasury noted the significant level of complexity associated with managing WRE deductions,³¹ and Chartered Accountants ANZ commented that:

...it takes a 25 page public ruling for the ATO to explain the general principles flowing from the legislation and judicial decisions on the deductibility of clothing, uniforms and footwear, with this ruling backed-up by even more public rulings on clothing etc for specific occupations.³²

2.24 As opposed to taxpayers who may be over-claiming for WRE deductions, others may be missing out due to the complexity of the current arrangements. Chartered Accountants ANZ suggested that individuals preparing their own tax returns may be disadvantaged by the complexities of WRE deductions, and could neglect to claim for items for which they are entitled:

In a self-assessment system, one can only sympathise with the self-preparer who seeks to plough through all the available guidance on what should be relatively straightforward personal deduction issues. We suspect few bother. Indeed, a sizeable number of self-preparers may actually forgo work-related deductions to which they are legitimately entitled, and lodge simply to obtain PAYG tax over withheld at source.³³

2.25 Mr Highfield suggested that with the generosity of the rules around WREs, concerns in the detection of refund fraud could be created for the ATO as the ATO has to refund large amounts. For example, almost one million refunds processed for the 2012-13 income year had an individual value in excess of \$6 000. Mr Highfield concluded that a simpler tax system with fewer deductions would mean greater precision of PAYG withholdings, enabling an increase in take-home pay.³⁴

31 Treasury, *Submission 19*, p. 8.

32 Chartered Accountants ANZ, *Submission 11*, p. 9.

33 Chartered Accountants ANZ, *Submission 11*, p. 9.

34 Mr Richard Highfield, Private capacity, *Committee Hansard*, Canberra, 5 February 2016, p. 9.

Deduction levels

- 2.26 According to recent ATO statistics, claims for WRE deductions have increased by 21 per cent over the past five years,³⁵ following the value of WRE deductions more than doubling from \$7 763 million in 1999-2000 to \$19 761 million in 2012-13.³⁶
- 2.27 It can be argued that the growth in recent years in WRE deduction claims by individuals indicate a need for reform in this area. Mr Highfield observed that:
- The incidence of deduction claims for work-related expenditure by taxpayers with taxable incomes in the ranges \$37 000 to over \$150 000 exceeds over 90%, suggesting considerable potential for some level of standardisation and simplification.³⁷
- 2.28 The Treasury recognised that some individuals will organise their financial arrangements to maximise the value of deductions, an action 'which can undermine the integrity and sustainability of the tax system'.³⁸ The Treasury added:
- Alternatively, some individuals may attempt to push the boundaries by increasing the value of their deductions. The tax benefit of this can be limited by the requirement that expenses should generally be apportioned based on how much is for private use.³⁹
- 2.29 ACOSS argued that determining the connection between the expense and the income is 'far from a precise science', and is an area where people 'are able to push the envelope'.⁴⁰ The Law Council of Australia emphasised that when talking about over-claiming, the distinction should be made between fraudulent claims, which are against the law, and 'those that are at the edge where there is some complexity and uncertainty around the law'.⁴¹

35 ATO, *Submission 1*, p. 4.

36 Chartered Accountants ANZ, *Submission 11*, p. 7.

37 Mr Richard Highfield, *Submission 20*, Attachment 1, p. [8].

38 Treasury, *Submission 19*, p. 8.

39 Treasury, *Submission 19*, p. 8.

40 Mr Peter Davidson, Senior Adviser, ACOSS, *Committee Hansard*, Canberra, 5 February 2016, p. 7.

41 Mr Adrian Varrasso, Taxation Committee Chairman, Law Council of Australia, *Committee Hansard*, Canberra, 5 February 2016, p. 15.

- 2.30 Chartered Accountants ANZ outlined three main areas in which individuals may not meet basic eligibility for deductions, as the WRE:
- Was not actually incurred – For example, there are employees who feel entitled to claim up to the full amount of work-related allowances received from their employer, even though the expenditure may not have been incurred. A common example here are claims made against a travel or meal allowance. Some taxpayers simply invent fictitious claims, often involving small amounts, hoping to fly below the ATO’s radar.
 - Does not meet the deductibility tests – The expenditure may be essentially private or domestic in nature. An example is the claiming of ordinary business attire as a deduction.
 - Does not satisfy the income tax substantiation rules – No receipts, log book or travel diary actually exist to substantiate the expenditure, even though the taxpayer may assert otherwise to the tax agent or the ATO.⁴²
- 2.31 During the engagement process for the *Re:think* Tax Discussion Paper, PricewaterhouseCoopers (PwC) noted that there is a perception that the \$300 substantiation requirement for WREs may provide taxpayers with the opportunity to over-claim WREs where they have not incurred the expense.⁴³ In relation to this, PwC stated that the requirement has not been the subject of general abuse.⁴⁴
- 2.32 The ACCI acknowledged that tightening access to WRE deductions warranted further investigation, but argued that any substantial changes ‘would be premature without much stronger evidence to suggest that a significant proportion of WRE deductions are being inappropriately claimed’.⁴⁵
- 2.33 Chartered Accountants ANZ noted that the ATO has undertaken some ‘tax gap’ analysis on the extent to which WREs are over-claimed, and suggested that the analysis would help the committee to determine the extent to which WRE deductions impact on the tax base.⁴⁶ A ‘tax gap’ is the difference between the estimated amount payable if there is full compliance and the amount that is actually collected.⁴⁷

42 Chartered Accountants ANZ, *Submission 11*, p. 4.

43 PricewaterhouseCoopers (PwC), *Submission to the Re: think Tax Discussion Paper*, Submission 2, p. 6.

44 PwC, *Submission to the Re: think Tax Discussion Paper*, Submission 2, p. 6.

45 ACCI, *Submission 15*, p. [3].

46 Chartered Accountants ANZ, *Submission 11*, p. 5.

47 ATO, *Commissioner of Taxation Annual report 2014-15 Volume 1*, p. 42.

- 2.34 The ATO advised that in recognition of the ‘high number of claims and high value’, it has always maintained a strong focus on WREs. In addition, due to the complexity of WREs, it focuses on education and advice to assist people to better engage in the process. It uses risk tools across returns to identify ‘abnormal claims’ and conducts full audits on the highest-risk cases.⁴⁸

Technological improvements and wider reform

- 2.35 Whilst currently, significant compliance requirements and costs are associated with Australia’s personal income tax system,⁴⁹ technological advancements could assist with simplifying taxpayers’ experiences in claiming deductions and lodging a tax return. The ATO has already been utilising technology to streamline tax processes. The Treasury advised that:

The ATO continues to seek opportunities to use technology to reduce complexity and compliance costs. In 2014, myTax was introduced, which offers a simple online interface through which most taxpayers with simple tax affairs can access and lodge tax returns pre-filled by the ATO. This is being rolled out to more taxpayers, and is expected to save approximately \$156 million in compliance costs each year. In 2015, the myDeductions tool was introduced, allowing individuals to capture, classify and pre-fill deductions in their tax return.⁵⁰

- 2.36 Mr Highfield noted the progress that had been made since 2007 that would enable the ATO to ‘prepare fully completed returns for the majority of taxpayers’:

A system of [pre-filling] tax returns is well established and taxpayers are familiar with the process of relying on income data accumulated for them by the ATO to [pre-fill] their tax returns, while user interfaces have recently been enhanced, and more is planned, to encourage further take-up. Finally, adequate security and authentication mechanisms appear to be in place.⁵¹

- 2.37 Moves towards simplification rest on the assumption that individuals will have less to do in compliance and administration. Whilst the current

48 Ms Alison Lendon, Deputy Commissioner, ATO, *Committee Hansard*, Canberra, 5 February 2016, p. 9.

49 Mr Richard Highfield, *Submission 20*, Attachment 1, p. [2].

50 Treasury, *Submission 19*, p. 8.

51 Mr Richard Highfield, *Submission 20*, Attachment 1, p. [15].

pre-filling undertaken by the ATO relies on the income data it receives, this is less straightforward in relation to deductions, as it does not receive third party data. The ATO advised the committee in relation to deductions that:

...we have released an app called myDeductions to help people document during the year, because we know one of the issues around deductions that are complex for people is keeping their records. People can miss out on things because they do not keep good records. We are looking at all those ways to simplify within the current system, but there is no doubt that if we can get more data to [pre-fill], that makes the overall experience for people faster and helps them get it right.⁵²

2.38 There have also been technological improvements and initiatives, such as the Single Touch Payroll, towards enabling PAYG withholding tax calculations to be more closely calibrated to individuals' specific circumstances.⁵³

2.39 CPA Australia argued that even if WRE deductions were removed, there are a number of reasons why individuals would still need to lodge a return. It commented in relation to technological developments and pre-filling that:

...we are in the digital age, processing down a path of making it simple for self-preparers and lodgers. Notwithstanding that, some of these same lodgers who at the moment are claiming a [work-related expense] are going to have a charitable deduction, a distribution from a family trust or a distribution from a partnership that will not be captured by the tax office or by 'big data' ...⁵⁴

2.40 CPA Australia expressed concern that changes could potentially result in shifting the compliance burden to employers.⁵⁵ This concern was shared by the ACCI, who argued against:

...the idea that employers could take on more of the reporting responsibilities. I think it makes sense where the information is

52 Ms Alison Lendon, Deputy Commissioner, ATO, *Committee Hansard*, Canberra, 5 February 2016, p. 17.

53 Chartered Accountants ANZ, *Submission 11*, p. 4.

54 Mr Paul Drum, Head of Policy, CPA Australia, *Committee Hansard*, Canberra, 5 February 2016, p. 10.

55 Mr Paul Drum, Head of Policy, CPA Australia, *Committee Hansard*, Canberra, 5 February 2016, p. 10.

already collected by the employer as part of their normal business processes, absent some costs of transitioning to digital systems, but it does not make sense where the employer is having to collect additional information from the employee... it just adds an extra administrative cost.⁵⁶

- 2.41 A number of submitters also suggested that changes to deductions should be considered in the context of wider reforms and the potential impacts on individuals, businesses and the wider economy.⁵⁷ For example, Research Australia commented that:

The twin objectives of a simpler tax system with a lower rate of tax can be met by removing some or all tax deductions. Notionally, eliminating tax deductions will lead to an increase in the rate of tax collected that can be returned to taxpayers as a lower rate of tax. Furthermore, making the tax system simpler should reduce the cost to government of collecting taxes, allowing rates to be even lower while simultaneously reducing the cost to individuals and companies of complying with their tax obligations.

If all individuals and all companies incurred the same costs in earning their income, this would be a reasonable approach. However this is not the case. The principle behind allowing tax deductions for income expenses is essentially one of fairness. Some people and companies incur greater expenses in earning their income than others, and the tax system accounts for this by allowing certain expenses to be claimed as a tax deduction.⁵⁸

International comparisons

- 2.42 The area of WREs received considerable coverage in submissions. International comparisons reflect that Australia has relatively generous WRE deduction provisions for individuals.⁵⁹

56 Mr Tim Hicks, Senior Manager, Australian Chamber of Commerce and Industry, *Committee Hansard*, Canberra, 5 February 2016, p. 21.

57 See for example Chartered Accountants ANZ, *Submission 11*, p. 19; ACOSS, *Submission 24*, p. 3; Mr Richard Highfield, *Submission 20*, p. [8], Attachment 1.

58 Research Australia, *Submission 1*, p. 5.

59 See Chapter One Table 1.1: International comparisons of deductions for WREs. See also PBO, *Submission 25*, p. 15, Table 4: Tax relief for work-related expenses for selected OECD countries; Treasury, *Submission 19*, p. 5, Table 3: Deductibility of work-related expenses for selected OECD countries; Mr Rob Heferen, Deputy Secretary, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 12.

- 2.43 The PBO noted that a number of OECD countries have circumvented the complexities that are inherent in the Australian treatment of WREs by tightening definitions of WREs or by making use of a standard deduction:

In contrast to Australia's tax-free threshold, a number of OECD countries have standard lump-sum or tapered tax allowances (or tax credits), a portion of which are intended to cover expenses in earning income. These expenses do not need to be substantiated or separately reported.⁶⁰

- 2.44 The Law Council of Australia noted that the UK, Canadian and the United States tax systems all allow employee deductions relating to deriving income, whereas they are prohibited in New Zealand.⁶¹

United Kingdom (UK)

- 2.45 The PBO noted the similarities of the Australian and UK tax structures and reporting systems, and stated that 'for 2012-13 the value of deductions as a proportion of total income was 3.0 per cent, compared to 4.2 per cent for Australia'.⁶²

- 2.46 It is worth noting that few individuals in the UK are required to lodge annual tax returns. Mr Highfield observed that in the UK system only a third of their employee population was required to file a return.⁶³ This is facilitated by the 'combined impact of several types of allowances, and an efficient, accurate mechanism for withholding tax at source'.⁶⁴ The UK system includes a withholding tax on interest, which, as a part of the wider withholding mechanisms, helps reduce individuals' obligation to report income.⁶⁵

- 2.47 Mr Highfield further commented that the other two-thirds now receive an end-of-year statement:

... a new development, which defines how much tax they have paid over the course of the year, what their income was from various sources of employment. It is a means of making the system more transparent to those employees who do not file a traditional type of tax return.⁶⁶

60 PBO, *Submission 25*, p. 14.

61 Law Council of Australia, *Submission 6*, p. 2

62 PBO, *Submission 25*, p. 14.

63 Mr Richard Highfield, Private capacity, *Committee Hansard*, Canberra, 5 February 2016, p. 12.

64 Chartered Accountants ANZ, *Submission 11*, p. 10.

65 Mr Richard Highfield, Private capacity, *Committee Hansard*, Canberra, 5 February 2016, p. 21.

66 Mr Richard Highfield, Private capacity, *Committee Hansard*, Canberra, 5 February 2016, p. 12.

2.48 In the UK, WREs are deductible, but come with a stringent test. Individuals can either claim a standard deduction (based on their occupation) that does not require substantiation, or can claim for actual expenses on eligible items, but ‘this requires substantiation and must satisfy the test of being incurred “wholly, exclusively and necessarily in the performance of an employee’s duties”’.⁶⁷ Education expenses are not allowed, however, an exception is made for ‘circumstances where education is part of the duties of the individual’.⁶⁸

2.49 The claimable items in the UK are also narrower than in Australia. For example, one element of the UK test for specific items claimed is that ‘a WRE is only deductible if it need be incurred by every holder of that form of employment – it is not enough that one employee, or a subset of employees, happens to incur the expense’.⁶⁹ The Treasury observed that:

Whilst the UK approach does not reduce the compliance burden for those people who specifically claim WRE deductions, it does narrow the deductions that may be claimed, which may in turn reduce the number of WRE claimants and the aggregate compliance burden imposed by the tax system.⁷⁰

2.50 However, the Treasury cautioned that in the UK system there is still ‘complexity that arises in people making judgements about what particular expenditure is deductible and what is not deductible’.⁷¹ It advised that:

The United Kingdom system would simply shift that boundary. So, there would still be uncertainty and debate either side of that line about whether something is in or out. But it does represent an alternative frame to view the issue through. Of course, which frame is correct or which frame best suits Australia is a policy question and not...[an] objective matter.⁷²

67 Treasury, *Submission 19*, p. 6; see also PBO, *Submission 25*, p. 14.

68 Research Australia, *Submission 1*, p. 7.

69 Treasury, *Submission 19*, p. 6.

70 Treasury, *Submission 19*, p. 6.

71 Mr Rob Heferen, Deputy Secretary, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 12.

72 Mr Rob Heferen, Deputy Secretary, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 12.

New Zealand

- 2.51 Tax reforms in New Zealand in the 1980s, which provided income tax cuts, also involved the removal of WRE deductions. Chartered Accountants ANZ emphasised that WREs were part of significant tax reforms in New Zealand and should not be considered in isolation.⁷³
- 2.52 New Zealand's *Income Tax Act 2007* (NZ) prohibits employment related deductions (the employment limitation). The Law Council of Australia explained the reasoning behind abolishing employment related deductions in New Zealand was to increase 'certainty in the tax system, the prevention of taxation abuse opportunities and the simplification of returns for both the taxpayer and revenue authority'. Further, the Law Council of Australia suggested that it was also a way of 'recognising the employer's responsibility to reimburse employee expenditure'.⁷⁴
- 2.53 A major part of the wider reforms in New Zealand was the reduction of the personal income tax rates. The Law Council of Australia noted that over the 25 years since abolishing personal income tax deductions, the highest personal income tax rate has 'gone from 66 [per cent] to 33 [per cent], as compared to the current Australian top marginal rate of 47 [per cent] (plus Medicare levy)'.⁷⁵ Mr Highfield noted that New Zealand has a different tax mix to Australia, and commented that:
- New Zealand does have lower personal rates of tax than Australia, but it also has a very broad goods and services tax and has the broadest base in the world of any tax. It raises three times the amount of revenue from its indirect taxes than Australia does...⁷⁶
- 2.54 The Treasury suggested that the absence of WRE deductions in New Zealand has reduced the number of people required to file a tax return and so consequently has been a 'major driver of compliance savings'.⁷⁷ As is the case with the UK system, Mr Highfield noted that New Zealand has a withholding tax on interest at source, which is not a feature of Australia's system.⁷⁸
- 2.55 Figures from the 2012-13 tax year indicated that approximately 37 per cent of New Zealand taxpayers filed tax returns (1.25 million of an estimated 3.3 million individual taxpayers), in contrast to Australia with

73 Chartered Accountants ANZ, *Submission 11*, pp. 10, 18.

74 Law Council of Australia, *Submission 6*, p. 2.

75 Law Council of Australia, *Submission 6*, p. 3.

76 Mr Richard Highfield, Private capacity, *Committee Hansard*, Canberra, 5 February 2016, p. 21.

77 Treasury, *Submission 19*, p. 6.

78 Mr Richard Highfield, Private capacity, *Committee Hansard*, Canberra, 5 February 2016, p. 21.

approximately 87 per cent (12.8 million returns filed out of 14.6 million working-age individuals).⁷⁹ It must be noted though that in New Zealand, broadly, individual tax returns are only required if the taxpayer earned income other than salary, wages, interest, dividends, and/or taxable Maori authority distributions,⁸⁰ as opposed to Australia where lodging a tax return is generally required, unless the individual falls into an exempt category.

Potential savings from improved compliance

2.56 During the public hearing on 29 March 2017, the committee questioned the ATO and The Treasury on the value of savings to the Budget that could be derived from improved compliance in relation to WREs.

2.57 The ATO noted in its submission that ‘the high value, number of claims and array of different individual circumstances require the ATO to maintain a strong focus on personal deductions’.⁸¹ The ATO further stated:

We are concerned about the level of non-compliance in relation to work-related expenses. While the amounts over-claimed by individuals are relatively small, they add up across the large population of individual taxpayers.⁸²

2.58 Given that the ATO reported Australians claimed \$21.8 billion worth of WREs in 2015,⁸³ the committee was interested in whether this figure was an accurate reflection of the actual cost of WREs to the Budget. The ATO agreed with the committee’s suggestion that the actual cost to the budget of WREs is substantially less than \$21.8 billion.⁸⁴ This is because while an individual can claim a certain amount, they only receive their tax deduction on the rate of tax that they would have otherwise paid.

2.59 The Treasury pointed out that the cost to the budget of WRE deductions also needs to factor in the behavioural change that results from any future changes to deduction arrangements, adding:

Obviously once you change what deductions might be available, you might expect there to be a behavioural response on the part of

79 Treasury, *Submission 19*, p. 6.

80 Chartered Accountants ANZ, *Submission 11*, p. 20.

81 ATO, *Submission 1 (45th Parliament)*, p. 4.

82 ATO, *Submission 1 (45th Parliament)*, p. 4.

83 ATO, *Submission 1 (45th Parliament)*, p. 4.

84 Ms Alison Lendon, Deputy Commissioner – Individuals, ATO, *Transcript*, 29 March 2017, p. 1.

taxpayers, and that might also ultimately have impacts on the budget.⁸⁵

- 2.60 The ATO commented that it had never produced figures on the actual cost of WREs to the Budget and stated that the ATO ‘cannot audit our way to success’:

In order to get a figure around that, we have to audit people that we would not normally go near or bother, because they are lower risk. There still might be a noncompliance factor, but they are lower risk. We have always put our attention on the higher-risk taxpayers. As you would appreciate, with 12 million taxpayers, we cannot audit our way to success around that.⁸⁶

- 2.61 When asked if the ATO has an estimate of the cost to the budget of non-compliance in relation to WREs – an issue that the ATO itself cited as a concern in its submission – the ATO replied that it did not have a figure ‘at this point in time’.⁸⁷

- 2.62 The ATO noted that it has ‘meetings scheduled with the tax gap panel for later this year’ and are expecting ‘to have some figures then’.⁸⁸

- 2.63 The committee was interested in how much the ATO has been able to ‘claw back’ by cracking down on compliance. The ATO responded:

We have adjusted around \$100 million from overclaiming, and...there are different components to it. There is the prevention component and the help and education that that delivers, which is very difficult to measure.⁸⁹

- 2.64 The ATO clarified that the \$100 million was recouped in the previous (2015/16) financial year. This work included about 100,000 interactions, and a subset of 6,000 to 7,000 high-risk individuals who are audited.⁹⁰

- 2.65 Given that there are 12 million individual taxpayers in Australia, this means that the \$100 million was derived from fewer than one in 1,000

85 Ms Maryanne Mrakovic, Deputy Secretary – Revenue Group, The Treasury, *Transcript*, 29 March 2017, p. 1.

86 Ms Alison Lendon, Deputy Commissioner – Individuals, ATO, *Transcript*, 29 March 2017, p. 2.

87 Ms Alison Lendon, Deputy Commissioner – Individuals, ATO, *Transcript*, 29 March 2017, p. 2.

88 Ms Alison Lendon, Deputy Commissioner – Individuals, ATO, *Transcript*, 29 March 2017, p. 3.

89 Mr Adam Kendrick, Assistant Commissioner – Individuals, ATO, *Transcript*, 29 March 2017, p. 4.

90 Mr Adam Kendrick, Assistant Commissioner – Individuals, ATO, *Transcript*, 29 March 2017, p. 4.

people being audited and one in 100 having some kind of interaction with the ATO.

- 2.66 When asked if these figures would lead a reasonable person to conclude that cost to the Budget of non-compliance is substantial, the ATO responded:

We are concerned about the size of the issue, and certainly the tax gap will help us understand more about that. At the simplest level, a small amount of noncompliance for an individual can lead to a big dollar, if you then apply it across the whole population.⁹¹

Options for simplifying personal deductions

- 2.67 In line with the inquiry terms of reference, the committee focused on options for broadening the tax base in order to fund reductions to individuals' tax rates. In the context of personal deductions, the committee considered whether restricting individuals' deductions could:

- simplify the current arrangements and reduce the significant compliance burden and associated administrative costs for taxpayers and the ATO; and
- deliver savings that could be used to lower the marginal tax rates for individuals more broadly.

- 2.68 Despite technological improvements and initiatives to address the compliance burden involved with lodging a tax return (as discussed above), this cannot fully address the complexity inherent in the arrangements for WRE deductions.

- 2.69 In evidence to the committee, Chartered Accountants ANZ outlined three possible models for reforming personal income tax deductions:

- Model 1 – focus on over-claiming of deductions.
- Model 2 – move to standard deductions, but with the option to substantiate if needing to claim an additional amount.

91 Ms Alison Lendon, Deputy Commissioner – Individuals, ATO, *Transcript*, 29 March 2017, p. 16.

- Model 3 – a no-deduction model focusing entirely on simplicity, or some variation thereof, with a tighter nexus for deductions.⁹²
- 2.70 Chartered Accountants ANZ largely dismissed the first model. It argued that the first model targeting over-claiming would not achieve the desired simplicity and instead would focus on getting revenue and ‘ploughing it back into a reduction rate’.⁹³
- 2.71 For the second model, as the most commonly claimed personal deduction, it is possible that if standard deductions for WREs were to be introduced, this could contribute to the feasibility of streamlining tax returns, as it would remove the need for itemising WREs. As discussed in Chapter One, a recommendation of the 2009 Australia’s Future Tax System (AFTS) Review (Henry Tax Review) was the introduction of a ‘standard deduction’ to cover WREs and the cost of managing tax affairs. This would remove the need to collect receipts for expenditure and so help to streamline the completion of tax returns, including reducing the need for assistance by tax agents for WRE deductions. Whilst taxpayers would continue to be able to claim WREs where they had claims above the standard deduction amount, this was also accompanied by a recommendation in the AFTS Review to tighten the nexus between the deductibility of WREs and its role in producing income.⁹⁴
- 2.72 When commenting on the considerable compliance burden in the Australian system, Mr Highfield stated:
- We currently have around nine million taxpayers making claims for work-related deductions. On average, those claims rise with income. It was in that context that the Henry review made a recommendation around a standard deduction with a threshold and with provision for exceptions – for people to opt out if they did not meet that particular form or prescription of a deduction.⁹⁵
- 2.73 However, while Chartered Accountants ANZ commented that the second model would be more equitable, it suggested that there was not likely to be significant dollar savings from this type of model.⁹⁶

92 Mr Matthew Hayes, Tax Consultant, Chartered Accountants ANZ, *Committee Hansard*, Canberra, 5 February 2016, pp. 20-21.

93 Mr Matthew Hayes, Tax Consultant, Chartered Accountants ANZ, *Committee Hansard*, Canberra, 5 February 2016, p. 20.

94 Australian Government, *Australia’s Future Tax System, Final Report, Part 2*, December 2009, Vol 1, pp. 57-59.

95 Mr Richard Highfield, Private capacity, *Committee Hansard*, Canberra, 5 February 2016, p. 9.

96 Mr Matthew Hayes, Tax Consultant, Chartered Accountants ANZ, *Committee Hansard*, Canberra, 5 February 2016, pp. 20-21.

2.74 In relation to the third model, some submitters supported simplifying the tax arrangements for WRE deductions. Chartered Accountants ANZ suggested that the simplest ‘clean slate’ approach to WRE deduction reform would be to remove these deductions, ‘subject to compensatory mechanisms’. The group also presented the following alternatives to a blanket denial of WREs:

- A minimum spend “floor”. A deduction is available only if the expenditure exceeds \$X
- A maximum deduction “cap”. A deduction is available only for expenditure up to a maximum amount of \$X, with the excess not deductible
- New eligibility criteria. For example, in Sweden, a home office expense is deductible only if the employer does not provide the taxpayer with an office. A similar approach applies to the deductibility of books and newspapers.⁹⁷

2.75 Some of these points were also made by KPMG, who took the view that:

...there should be a threshold under which no work related expenses should be claimed by individuals. Above the threshold, claims can be made on proof of expenditure, but subject to a cap. The cap should be fixed and the threshold indexed so that deductibility of work related expenses would be phased out over time. There should be no attempt to distinguish between good and bad work related expenses and no flow through to employers if similar payments were to be made by the employer. This is an example where simplicity should be paramount.⁹⁸

2.76 KPMG elaborated on this model in evidence to the committee:

The motivation behind the proposal...is really based on simplicity. It is very hard to delineate between what might be called ‘good’ and ‘bad’ work-related expenses.⁹⁹

2.77 Chartered Accountants ANZ thus observed that the third model is a ‘simplicity wins out’ model, and stated:

...the KPMG model would be a no-deduction model. You can have variations of that. For example, rather than no deduction, you could have tighter nexus. It seems to me that, at one end, the equity is winning out. At the other end, if you truly want to

97 Chartered Accountants ANZ, *Submission 11*, p. 7.

98 KPMG, *Submission 10*, p. 1.

99 Mr Grant Wardell-Johnson, Partner, KPMG, *Committee Hansard*, Canberra, 5 February 2016, p. 13.

dramatically take complexity out, then simplicity wins out. There are no good or bad expenses at that end. For each expense, whether it be child care or self-education, you can justify those deductions; that is not the point. Simplicity wins out. But, at the end of the spectrum, you clearly have heaps and heaps of winners and losers. And that is the challenge...¹⁰⁰

- 2.78 For further means of simplification of the tax return process, Chartered Accountants ANZ noted that they have ‘long questioned why Australia has not to date embraced a “no or simple tax returns policy” for individuals with straightforward tax affairs who can rely on pre-fill data’.¹⁰¹
- 2.79 When considering potential revenue gains from changes to deductions, it is also important to note PBO’s advice that calculating revenue implications of changes to deductions is not straightforward.¹⁰² For example, an estimation of the financial impact would require a consideration of the behavioural responses of taxpayers and the broader macroeconomic impacts.¹⁰³
- 2.80 During the roundtable public hearing, the PBO noted during its overview of personal income tax deductions:
- The third point that comes out of this-it goes back to revenue neutrality-is that, if you are going to have revenue-neutral reform, given that there is in fact an uneven distribution of deductions between taxpayers, then that uneven distribution means you are going to have winners and losers. So, with any reform in this area, you are going to have to also determine what the level of winners and losers is that you are prepared to bear.¹⁰⁴
- 2.81 Where it was raised in evidence to the committee that figures from the Tax Expenditures Statement may assist in estimations, the Treasury clarified:
- The Tax Expenditures Statement does not measure revenue that the government could otherwise get...Indeed, the issues we are talking about in relation to work-related expenses – that is not a
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100 Mr Matthew Hayes, Tax Consultant, Chartered Accountants ANZ, *Committee Hansard*, Canberra, 5 February 2016, pp. 20-21.

101 Chartered Accountants ANZ, *Submission 11*, p. 9.

102 Mr Colin Brown, First Assistant Parliamentary Budget Officer, PBO, *Committee Hansard*, Canberra, 5 February 2016, p. 3.

103 PBO, *Submission 25*, p. 6.

104 Mr Colin Brown, First Assistant Parliamentary Budget Officer, PBO, *Committee Hansard*, Canberra, 5 February 2016, p. 12.

tax expenditure. By definition, that cannot be a tax expenditure because it is trying to get at what taxable income is. Other things, like net rental losses, are not tax expenditures. They are getting at what the correct amount of tax paid might be given the taxable income being the subject of taxation. That is something that is often put into public domain; 'Here is this amount of money that the government could have.' It is not a measure of that, it is not meant to do that and it is not designed to do that, but unfortunately it is sometimes reported as such.¹⁰⁵

Arguments for removing WRE deductions

2.82 While groups acknowledged the underlying appeal of tax simplification, there was limited support amongst submitters for removing WREs. KPMG, however, argued that Australia's tax system was 'ripe for simplicity' and supported replacing WRE deductions with lower personal tax rates:

To give effect to our recommendation, there should be a limitation on work related expenses up to a particular limit. Expenditure above that limit could be claimed with proof of expenditure, but with a cap. The cap could be a fixed amount and the threshold could be indexed to wage inflation such that work related expenses are fully "cashed out" over time. By "cashed out" we mean eliminated and converted into lower personal tax rates.

Tax systems are generally evaluated on fairness, efficiency and simplicity. Rarely does simplicity win out in the Australian tax system. This is ripe for simplicity. Trying to delineate between good and bad work related expenses and to provide non-deductibility for equivalent expenditure for businesses is fraught with complexity out of all proportion to the taxation impacts.¹⁰⁶

2.83 Most submitters acknowledged the complications associated with the current arrangements for deductions, in particular WREs, but few expressed outright support for the removal of personal deductions, or at least qualified their support by raising concerns about potential unintended consequences of such changes (as discussed below).

105 Mr Rob Heferen, Deputy Secretary, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 13.

106 KPMG, *Submission 10*, p. 2.

2.84 One approach to address these concerns is that any reduction or removal of WRE deductions should be accompanied by complementary relief for taxpayers. Chartered Accountants ANZ noted that:

...some will draw a connection between the current ATO push to increase online services to taxpayers and any policy decision to withdraw deduction entitlements. Without meaningful compensating benefits flowing to taxpayers such as personal income tax rate relief, cynics will argue that the benefits of such changes to the personal tax system accrue solely to the Government (in terms of increased tax collections) and to ATO (through lower tax collection costs).¹⁰⁷

2.85 Chartered Accountants ANZ acknowledged the likelihood of resistance to the treatment of WRE deductions, and contended that any changes:

- Would need to be accompanied by contemporaneous consequential reductions in the personal tax rate (particularly in the rate bands that impact the majority of Australian individual taxpayers).
- For employees, the benefit of the reduced rates of personal taxation would need to be reflected in take-home pay, with a reduction in the extent of current over-withholding at source.
- Should be accompanied by legislative changes which dramatically reduce and simplify the tax compliance obligations of individuals with straightforward tax affairs such that, except where fraud or evasion is detected, they have minimal obligations vis-à-vis the ATO.¹⁰⁸

Arguments for retaining deductions

2.86 There were a range of arguments in support of retaining WRE deductions, and cautioning against making any changes that are not part of a comprehensive reform of tax deduction arrangements. Arguments raised by groups included:

- equity concerns and the potential effects it may have on individuals and employees in particular sectors who rely on certain WRE deductions, such as self-education expenses;
- how the removal of deductions may influence individuals' behaviours and may lead to unintended consequences; and

107 Chartered Accountants ANZ, *Submission 11*, pp. 4-5.

108 Chartered Accountants ANZ, *Submission 11*, pp. 10-11.

Equity issues—potential effects

- 2.87 Research Australia asserted that the ‘principle behind allowing tax deductions for income expenses is essentially one of fairness’, as ‘some people and companies incur greater expenses in earning their income than others, and the tax system accounts for this by allowing certain expenses to be claimed as a tax deduction’.¹⁰⁹
- 2.88 The ACCI cautioned in relation to standard deductions that:
- A standard deduction would provide simplification, but a standard deduction without other changes would come at a high cost to revenue as everyone below the threshold would claim it, while everyone with expenses above the standard deduction would continue to claim.
- Pairing a standard deduction with a tighter nexus between expenses and work could offset the costs of a standard deduction and may still provide a significant net positive to revenue that could be used to lower overall tax rates. However, many of the expenses ruled out under a tighter nexus could be legitimate. For example, ruling out self-education expenses may lead to a substantial underinvestment in human capital.¹¹⁰
- 2.89 The Institute of Public Accountants attributed the lack of reform in relation to deductions in part to ‘fairness and equity’ considerations, and argued against imposing a cap on deductions. It noted that a significant number of the population on low incomes make workplace deductions, and described a cap as a ‘blunt instrument’ that ‘would give a free kick to all those who do not have any deductible expenses’.¹¹¹ Similarly, CPA Australia observed that governments have recognised and struggled to address a ‘raft of equity issues’ in relation to deductions for individuals.¹¹²

Self-education expenses

- 2.90 While not the largest category of WRE deductions claimed, a number of submitters raised concerns about the potential removal of self-education expenses. Self-education expenses accounted for \$1.1 billion in claims in 2012-13, in contrast to the largest claimed area of car expenses, with

109 Research Australia, *Submission 1*, p. 5.

110 ACCI, *Submission 15*, p. [2].

111 Mr Tony Greco, General Manager, Institute of Public Accountants, *Committee Hansard*, Canberra, 5 February 2016, p. 7.

112 Mr Paul Drum, Head of Policy, CPA Australia, *Committee Hansard*, Canberra, 5 February 2016, p. 7.

\$8.0 billion in claims; approximately 5 per cent and 40 per cent, respectively.¹¹³

- 2.91 Self-education deductions provide support for individuals to undertake education related to their current employment. Research Australia acknowledged the significance of education to the Australian economy, stating that:

It is increasingly recognised by the Australian Government that Australia's future is dependent on a highly educated and productive workforce, and that the rapid rate of technological change means that Australians need a lifelong approach to learning if we are to prosper in the 21st century. In this context, it makes sense for the Government to provide incentives for individuals to invest in their own ongoing education. Providing a tax deduction for self-education expenses encourages individuals to take responsibility for their own ongoing education while assisting them to meet the cost of doing so. Removing the deductibility of self-education expenses to fund a lower tax rate would remove this incentive for continuing education.¹¹⁴

- 2.92 Chartered Accountants ANZ also raised the potential implications for work-related education, and suggested that the committee reflect on:

The outcry from education providers which greeted the former Labor Government's proposed cap on self-education deductions. These representations reflected not only concerns about the viability of education programs offered by organisations (including Chartered Accountants Australia and New Zealand), but also the long-term economic impact of a tax system which no longer supported self-funded study leading to work related knowledge growth and possible career advancement. These issues take on added importance in a digital age where some workers are expected to be displaced and need to acquire new skills.¹¹⁵

- 2.93 Research Australia, which represents the health and medical research sector, highlighted the importance of the self-education expenses deduction for the sector. It argued that these researchers would be 'disproportionately and unfairly' disadvantaged by a decision to remove the deductibility of self-education expenses and that 'any "across the board" reduction in the tax rate based on the average value of the
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113 PBO, *Submission 25*, p. 3.

114 Research Australia, *Submission 1*, p. 7.

115 Chartered Accountants ANZ, *Submission 11*, p. 6.

deduction to taxpayers would be insufficient to offset the loss of this tax deduction'.¹¹⁶

2.94 Research Australia argued that a lower tax rate to compensate for the removal of deductions for self-education expenses would not address the cost to the community as a result of the effect on the sector.¹¹⁷ It was noted that health and medical researchers have 'relatively low levels of permanent ongoing employment', which tends to mean that 'researchers are largely responsible for their own professional development and continuing education, and this includes paying to attend conferences and seminars, and for other training activities'.¹¹⁸

2.95 This, combined with the potential disincentive for employers if fringe benefits tax costs are incurred, could result in an individual not receiving support or having no incentive to undertake education and training.

2.96 In contrast, ACOSS took a broader view on this issue and argued in relation to the education needs of certain sectors that:

If it is so essential to the work of these people, why isn't the employer paying? And if the employer is not paying, what does that say about the funding of and investment in research and development in Australia? I think there is a more fundamental problem, here, that we cannot paper over through the personal tax system.¹¹⁹

2.97 As noted, a number of groups were concerned about the removal of deductions for self-education expenses, and the effect this would have on individuals' behaviour and more broadly in the economy. The Law Council of Australia opposed caps being applied to deductions for self-education expenses,¹²⁰ and argued that:

...a cap would also result in discouraging expenditure by individuals on improving their existing skill base. Though perhaps unintended, the suppression of skilling up, if not deskilling, of the workforce and businesses will occur.¹²¹

116 Research Australia, *Submission 1*, p. 8.

117 Research Australia, *Submission 1*, p. 8.

118 Research Australia, *Submission 1*, pp. 5-6.

119 Mr Peter Davidson, Senior Adviser, Australian Council of Social Service, *Committee Hansard*, Canberra, 5 February 2016, p. 14.

120 Law Council of Australia, *Submission 6*, p. 2.

121 Law Council of Australia, *Submission 6*, p. 3.

2.98 Similarly, the Housing Industry Association (HIA) observed that removing or reducing specific deductions are ‘likely to distort consumption in a way that is detrimental’.¹²² The HIA identified self-education as a notable example of a tax transfer providing an incentive to undertake further training, and stated that:

This transfer amounts to a public investment in building the productive capacity of the nation’s workforce. Whether the ability to deduct education expenses from income earned is the most efficient form of incentive is beyond the scope of this submission. However, disallowing deductions for employment related self-education expenses without an appropriate compensatory incentive risks impeding labour productivity improvements.¹²³

Changing behaviours and unintended consequences

2.99 The PBO indicated that changes to tax rules will result in behavioural changes, and observed that:

...the way that people are able to claim, the rules around it and the system itself create incentives, so what we have got will already have a behavioural consequence. People have modified their behaviour to fit the rules, so, if the rules change, you can expect that that will result in a change in behaviour.¹²⁴

2.100 As noted by the Chartered Accountants ANZ, the extent of deductibility ‘encourages expenditure which produces desirable economic and/or social outcomes’.¹²⁵ Accordingly, a number of groups cautioned against considering changes to personal tax deductibility in isolation, as reform in one area can result in changes in behaviours by individuals that will impact other areas. For example, CPA Australia warned that ‘[workers] may choose to... not invest in work-related tools and equipment.’¹²⁶

2.101 Similarly, Chartered Accountants ANZ made the point that:

any policy decision to totally or partially deny employees deductibility for certain types of otherwise deductible workplace expenditure (e.g. travel, uniforms, telephone calls, tools and equipment with associated capital allowances) is itself

122 Housing Industry Association (HIA), *Submission 13*, p. 2.

123 HIA, *Submission 13*, p. 2.

124 Mr Colin Brown, First Assistant Parliamentary Budget Officer, PBO, *Committee Hansard*, Canberra, 5 February 2016, p. 5.

125 Chartered Accountants ANZ, *Submission 11*, p. 6.

126 CPA Australia, *Submission 32*, p. 2.

distortionary, with some taxpayers likely to adapt by simply changing their tax strategy.¹²⁷

2.102 One unintended consequence that could result from the removal of WRE deductions is that employees may find it more beneficial for tax purposes to be identified as contractors rather than employees, in order to access deductions currently claimed as WREs under a business structure. As Chartered Accountants ANZ stated, 'a change to the deductibility of an employee's work-related expenses would encourage some taxpayers to consider working as a *self-employed contractor* and – assuming the alienation of personal services income rules and the general anti-avoidance rule in the income tax law were not attracted – claiming the deductions as a taxpayer carrying on business'.¹²⁸ Chartered Accountants ANZ also suggested that this type of behaviour is already evident in businesses, particularly in the building and construction, and transport and rural sectors.¹²⁹

2.103 Further, the group noted the presence of issues related to employees and contractors already in the Australian tax system at the federal and state levels, and observed that:

Changing deduction entitlements for one taxpayer segment (employees) but not another (self-employed individuals) when both would benefit from any promised personal tax rate reductions is, to say the least, difficult.¹³⁰

2.104 However, the Treasury noted that in making such a decision, individuals will not only have regard to tax implications, but consider the impact of contractor status in relation to insurance requirements and the potential loss of leave entitlements and superannuation contributions received as employees.¹³¹

2.105 Another area that could be affected is the consumption choices of individuals. For example, Chartered Accountants ANZ noted that June sales on items such as personal electronic devices, computers, software and tools of trade are in part based on taxpayers anticipating some form of 'cash back' in tax refunds on the purchases which can be claimed as WRE deductions. Even more significantly, it could impact on the 'expenditure on protective items used at work where these items are not employer (or

127 Chartered Accountants ANZ, *Submission 11*, p. 2.

128 Chartered Accountants ANZ, *Submission 11*, p. 2.

129 Chartered Accountants ANZ, *Submission 11*, p. 3.

130 Chartered Accountants ANZ, *Submission 11*, p. 3.

131 Treasury, *Submission 19*, p. 8.

payer) provided', which could have broader implications for workplace safety issues, laws and agreements, and considering whether these are now items that the employer should be obliged to provide to workers.¹³²

- 2.106 The PBO commented that to effectively estimate the financial impact of any reforms to deductions, one of the elements that will need to be considered is how individuals will adjust their behaviours and tax arrangements in response to policy changes.¹³³ The PBO advised that looking at tax deductions and trying to determine what the financial impact of a change will be is an area of 'great uncertainty', and provided the example of an individual purchasing their own tools of trade and claiming it as a WRE:

...if those expenses were made non-deductible, a possible response is that that cost is shifted from the employee to the employer. The net result of that, depending on how it is done, may be that the revenue gain anticipated by moving the [work-related] expense is in fact fully negated. That is an extreme case. It would necessarily be that it was fully negated as different people respond in different ways...¹³⁴

Fringe benefits tax (FBT) and employer impacts

- 2.107 Under the current system, FBT is not payable by employers when providing to employees benefits that would otherwise be deductible if purchased by the employee.¹³⁵ Consequently, the removal of WRE deductions would have FBT implications for employers. Any changes to the rules around WRE deductions would need to be considered alongside the FBT regime,¹³⁶ otherwise this could result in employees being disadvantaged as employers may discontinue providing these benefits to avoid incurring negative FBT impacts.
- 2.108 Chartered Accountants ANZ highlighted that there are also equity concerns where changes to WREs could disproportionately affect some employees, as some employers would absorb the cost of FBT and others would pass it on.¹³⁷

132 Chartered Accountants ANZ, *Submission 11*, p. 6.

133 PBO, *Submission 25*, p. 6.

134 Mr Colin Brown, First Assistant Parliamentary Budget Officer, PBO, *Committee Hansard*, Canberra, 5 February 2016, p. 3.

135 Treasury, *Submission 19*, p. 9.

136 Treasury, *Submission 19*, p. 9.

137 Chartered Accountants ANZ, *Submission 11*, p. 8.

2.109 As a further consideration, the HIA stated that narrowing the scope of allowable deductions could affect individuals' spending behaviour, consequently impacting business:

A reduction or removal of deductibility may see individuals elect to incur fewer employment related expenses, which may see a partial transfer of expenditure to businesses or businesses may experience a reduction in productivity as they no longer benefit from individual's personal expenditure on items used in their employment.¹³⁸

2.110 It was suggested that the current system allows for a diversity of WRE deductions that can vary between occupations¹³⁹ and, according to an article referenced in the Chartered Accountants ANZ submission, can produce 'arbitrary and inequitable' outcomes,¹⁴⁰ however:

...those taxpayers whose circumstances receive beneficial tax recognition are unlikely to agree, particularly where the supply-demand aspects of the relevant market for labour gives the employer (payer) little incentive to provide the inputs for which the employee (payee) previously received a deduction. For example, a potential employee in a trade where there are no skill shortages might not be hired unless he or she is prepared to purchase the relevant work-related equipment.¹⁴¹

2.111 Nonetheless, the article recognised that in areas where there are skill shortages and employers are seeking to hire labour, these employers 'may oppose changes to the tax treatment of work-related expenses "because they would foresee the resultant pressures for wage increases and the need to bear some of the costs previously borne by employees"'.¹⁴² Chartered Accountants ANZ thus encouraged consideration to be given to the broader aspects of the rules surrounding WREs.¹⁴³

138 HIA, *Submission 13*, p. 2.

139 There are WRE deductions that are specific to certain industries and occupations that can be claimed, see < <https://www.ato.gov.au/Individuals/Income-and-deductions/In-detail/Deductions-for-specific-industries-and-occupations/Deductions-for-specific-industries-and-occupations/>>, viewed 23 February 2016.

140 Chartered Accountants ANZ, *Submission 11*, p. 5. Reference is made to an article by Jonathan Baldry, *Abolishing Income Tax Deductions for Work-Related Expenses*, Agenda Vol 5, No, 1, 1998, pp. 49-60.

141 Chartered Accountants ANZ, *Submission 11*, p. 5.

142 Chartered Accountants ANZ, *Submission 11*, p. 6. Reference is made to an article by Jonathan Baldry, *Abolishing Income Tax Deductions for Work-Related Expenses*, Agenda Vol 5, No, 1, 1998, pp. 49-60.

143 Chartered Accountants ANZ, *Submission 11*, p. 6.

Community attitudes and understanding

- 2.112 The financial impacts aside, Chartered Accountants ANZ suggested that community attitudes are another layer of challenge when governments attempt tax reform, particular in relation to WREs, as ‘many Australians have come to regard work-related deductions as an entitlement which contributes to the quantum of the annual after tax income they receive (not to mention a welcome bit of lump sum spending money)’.¹⁴⁴ Similarly, the Property Council of Australia described the ‘ability to claim legitimate expenses against your income’ as an ‘intrinsic and fundamental part of the tax system’.¹⁴⁵
- 2.113 Chartered Accountants ANZ noted that individuals can see claiming deductions as a ‘square-up’ opportunity, and ‘fail to realise that the refunded amount represents over-withholding at source and that the refund could have been reflected in their pay packets had the rate of withholding been more closely calibrated to their personal circumstances’.¹⁴⁶¹⁴⁷
- 2.114 Chartered Accountants ANZ surmised that as societal attitudes on WREs are well-entrenched, ‘policy changes in this area need to be well-prepared and presented, with sufficiently enticing trade-offs to wean taxpayers off the annual tax refund entitlement mentality’.¹⁴⁸
- 2.115 Further, some groups argued that underlying this attachment to deductions is a lack of understanding by the public about how much they are actually getting back when claiming deductions. For example, CPA Australia stated that:
- Most of the public – quite educated people, people with multiple degrees, although perhaps not in the business, accounting or legal fields – think they are getting dollar for dollar back. They do not realise it depends on their marginal rate.¹⁴⁹
- 2.116 ADJ Consultancy Services suggested that to change community attitudes, the Government will need to ‘go back to basics and explain to people

144 Chartered Accountants ANZ, *Submission 11*, p. 3.

145 Mr Ken Morrison, Chief Executive, Property Council of Australia, *Committee Hansard*, Canberra, 5 February 2016, p. 8. See also Mr Adrian Varrasso, Taxation Committee Chairman, Law Council of Australia, *Committee Hansard*, Canberra, 5 February 2016, p. 15.

146 Chartered Accountants ANZ, *Submission 11*, p. 4.

147 Chartered Accountants ANZ, *Submission 11*, p. 3.

148 Chartered Accountants ANZ, *Submission 11*, p. 4.

149 Mr Paul Drum, Head of Policy, CPA Australia, *Committee Hansard*, Canberra, 5 February 2016, p. 7.

exactly how the deductions work',¹⁵⁰ and make it clear to Australian taxpayers that:

...it is about your money coming back to you and you having more choices globally about how you spend what you have earned, and by the way, most of you will not have to file a mountain of documents or go to a tax agent, because we're going to do that ourselves.¹⁵¹

PBO Budget Analysis – Personal Income Tax Deductions

- 2.117 The committee believed it was essential to compare the value of tax deductions against estimates of revenue forgone as the latter figure provides a more indicative value of the cost of deductions to the Budget.
- 2.118 The Parliamentary Budget Office (PBO) provided an estimate of the real cost of selected personal income tax deductions in each year of the 2015-16 Budget forward estimates period, by financial year assessed.¹⁵² The total amount of deductions claimed over the years 2015-16 to 2018-19 is shown in Table 2.2. The revenue forgone estimates are presented as both their dollar value in Table 2.3 and as a proportion of total forecast personal income tax collections in Table 2.4.
- 2.119 Table 2.2 shows the total value of WREs claimed in 2015-16 is just over \$23 billion.
- 2.120 Table 2.3 shows that estimates of revenue forgone in 2015-16 are close to \$13.5 billion, rising to about \$14.5 billion in 2018-19. In relation to WREs, Table 2.3 shows that the estimates of revenue foregone is \$8.4 billion in 2015-16, rising to just over \$9 billion in 2018-19.
- 2.121 Importantly, the PBO noted that these estimates of revenue forgone (Table 2.3) are not estimates of the financial impact of removing these selected personal income tax deductions, since the potential impact of behavioural responses is not taken into account:

150 Mr Adam Johnston, ADJ Consultancy Services, *Committee Hansard*, Canberra, 5 February 2016, p. 6.

151 Mr Adam Johnston, ADJ Consultancy Services, *Committee Hansard*, Canberra, 5 February 2016, p. 13.

152 The PBO notes this analysis is considered to be of medium reliability as it is based on detailed administrative data from 2012-13 and estimated for the 2015-16 Budget forward estimates period. The PBO response is shown in full at Appendix C.

The revenue forgone estimates represent the expected amount by which these deductions reduce personal income tax collections in the financial year (as such it shows existing utilisation). They are not an estimate of the financial impact of removing these personal income tax deductions. A costing of such a proposal would require consideration of the potential behavioural response of taxpayers to the removal of these deductions.¹⁵³

- 2.122 Table 2.4 shows that revenue forgone from selected tax deductions, as a percentage of total individual and other withholding tax revenue for 2015-16 is 6.97 per cent, falling slightly to 6.25 per cent in 2018-19.

153 See: Appendix C, Parliamentary Budget Office, Response to Budget Analysis Request: Personal Income Tax Deductions, 7 April 2016.

Table 2.2 Personal income tax deductions – total, 2015-16 to 2018-19

	2015-16		2016-17		2017-18		2018-19	
	Number	\$m	Number	\$m	Number	\$m	Number	\$m
Work-related expenses ^(a)	9,358,000	23,270	9,471,000	24,170	9,591,000	25,190	9,717,000	26,330
Personal superannuation contributions	216,000	3,410	219,000	3,480	222,000	3,550	226,000	3,620
Cost of managing tax affairs	6,915,000	2,860	7,011,000	3,030	7,111,000	3,240	7,216,000	3,450
Gifts or donations	5,042,000	2,780	5,112,000	2,960	5,187,000	3,170	5,263,000	3,400
Dividends deductions	298,000	1,450	303,000	1,560	308,000	1,630	314,000	1,710
Interest deductions	410,000	830	417,000	830	423,000	870	431,000	910
Other deductions ^(b)	1,082,000	2,260	1,097,000	2,400	1,112,000	2,550	1,128,000	2,720
Total deductions^(c)	11,525,000	36,860	11,678,000	38,420	11,841,000	40,200	12,011,000	42,140

(a) Work related expenses include car-related expenses, travel expenses, clothing expenses, self-education expenses and other work related expenses.

(b) Low value pool deduction, deductible amount of undeducted purchase price of a foreign pension or annuity, deduction for project pool, forestry managed investment scheme deductions, election expenses and other deductions.

(c) The total number of taxpayers claiming deductions in each year does not equal the sum of the number claiming individual types of deduction, due to some taxpayers claiming more than one type of deduction.

Source Parliamentary Budget Office, Response to Budget Analysis Request, Personal Income Tax Deductions, 7 April 2016. [Appendix C]

Table 2.3 Revenue forgone from selected personal income tax deductions, 2015-16 to 2018-19

(\$m)	2015-16	2016-17	2017-18	2018-19
Work-related expenses ^(a)	8,400	8,370	8,740	9,050
Personal superannuation contributions	1,320	1,340	1,370	1,380
Cost of managing tax affairs	940	970	1,040	1,090
Gifts or donations	1,030	1,070	1,140	1,200
Dividends deductions	600	570	620	640
Interest deductions	350	300	300	310
Other deductions ^(b)	810	840	900	940
All selected deductions	13,490	13,510	14,160	14,670

(a) Work related expenses include car-related expenses, travel expenses, clothing expenses, self-education expenses and other work related expenses.

(b) Low value pool deduction, deductible amount of undeducted purchase price of a foreign pension or annuity, deduction for project pool, forestry managed investment scheme deductions.

Source Parliamentary Budget Office, Response to Budget Analysis Request, Personal Income Tax Deductions, 7 April 2016. [Appendix C]

Table 2.4 Revenue foregone from selected personal income tax deductions as a percentage of total individuals and other withholding tax revenue, 2015-16 to 2018-19

	2015-16	2016-17	2017-18	2018-19
Total personal income tax revenue (\$m)	193,360	204,790	218,750	234,750
Proportion of individuals and other withholding tax revenue (%)				
<i>Work-related expenses^(a)</i>	4.34	4.09	4.00	3.86
<i>Personal superannuation contributions</i>	0.68	0.65	0.63	0.59
<i>Cost of managing tax affairs</i>	0.49	0.48	0.47	0.47
<i>Gifts or donations</i>	0.53	0.52	0.52	0.51
<i>Dividends deductions</i>	0.31	0.28	0.28	0.27
<i>Interest deductions</i>	0.18	0.15	0.14	0.13
<i>Other deductions^(b)</i>	0.42	0.41	0.41	0.40
All selected deductions	6.97	6.60	6.47	6.25

(a) Work related expenses include car-related expenses, travel expenses, clothing expenses, self-education expenses and other work related expenses.

(b) Low value pool deduction, deductible amount of undeducted purchase price of a foreign pension or annuity, deduction for project pool, forestry managed investment scheme deductions, election expenses and other deductions.

Source Parliamentary Budget Office, Response to Budget Analysis Request, Personal Income Tax Deductions, 7 April 2016. [Appendix C]

Conclusions

- 2.123 The committee recognises that claiming deductions, in particular WREs, has been an enduring part of the Australian personal income tax system. The ability to claim deductions for valid work related expenses is an entirely appropriate part of our taxation system. It is and remains a principle that is supported by the committee.
- 2.124 Any decision to change the current system could create significant uncertainty for millions of Australian workers who are currently making valid claims for WREs. The removal of the ability to claim WREs would disadvantage people who currently use the WRE system to claim legitimate work expenses as a tax deduction. At the same time, the potential revenue saved if income tax deductions were broadened would be marginal. Modelling by the PBO noted that revenue foregone from WREs in 2015-16 amounted to \$8.4 billion which is 4.3 percent of total individual and other withholding tax revenue. Therefore, the committee notes that there are limitations in how much revenue neutral reform can be achieved by broadening personal income tax deductions in order to fund cuts in personal income tax rates. It is clear, however, that proposals to broaden personal income tax deductions could result in significant change and uncertainty without evidence of substantial improvement for tax payers generally.
- 2.125 It is also clear that it is not possible to reduce the cost to the budget of workplace deductions without leaving a significant number of taxpayers worse off.
- 2.126 The proposal to introduce a system where all taxpayers could claim a standard WRE deduction without substantiation, coupled with the ability to make additional WRE claims with substantiation, is not supported by the committee. While this system would have the benefit of simplicity, it would be likely to come at an additional cost to government revenue. This is the case because all taxpayers would be able to claim the standard deduction, while those with substantial workplace expenses would still be able to claim their existing WREs. The overall impact of this would most likely be an increase in the total cost of WREs.
- 2.127 While acknowledging that most Australians do the right thing when it comes to claiming WREs at tax time, the committee is aware that these deductions represent a significant cost to the budget and that there is real potential for overclaiming and noncompliance.

- 2.128 The committee is concerned the ATO was unable to quantify the actual cost to the Budget of WREs at the hearing. This is a fundamental oversight by the ATO and The Treasury, given that \$21.8 billion in WRE deductions were *claimed* in 2015. Estimates of the actual cost of WRE deductions to the Budget, including estimates of compliance, would provide a sounder basis for considering policy settings than figures currently in use.
- 2.129 The committee recognises the ATO has delayed releasing a number of tax gap estimates citing ‘the need to undertake further work to ensure that the estimates are as reliable and credible as possible’.¹⁵⁴ The committee understands that figures relating to tax gap estimates for Individuals, including the value of WRE overclaiming, will be released by the ATO later this year and, as a consequence, it would be premature for the committee to draw further conclusions at this time.
- 2.130 The committee recognises the ATO’s progress in improving the compliance burden on taxpayers. Developments in technology and ATO progress in pre-filing have already started to provide the technological platform for a simpler and more streamlined tax return process. The committee believes that the ATO should continue this progress and build upon further developments in technology to improve taxpayers’ experiences with the tax system.

Recommendation 1

- 2.131 **The committee recommends that the Government maintain the current personal income tax framework that allows Australians to claim deductions for valid expenses, including those related to their work. The committee sees this as an entirely appropriate part of our taxation system.**

While there are opportunities to improve the operation of the system, the committee supports the ongoing ability of Australians to claim legitimate deductions.

¹⁵⁴ ATO, *Submission 1 (45th Parliament)*, p. 4.

Recommendation 2

- 2.132 The Committee recommends that the Australian Taxation Office be instructed to analyse each detailed subcategory of tax deductions and identify areas that it believes are particularly open to systemic abuse and overclaiming.

The Australian Taxation Office should then rank these subcategories in order of the size of the financial risk they represent to Government revenue, and recommend amendments to law or policy where appropriate.

Recommendation 3

- 2.133 The committee recommends that Treasury be required as a matter of priority to provide a clear estimate of the actual cost to Government revenue of Work Related Expenses as necessary to properly inform policy in this area.

Recommendation 4

- 2.134 The committee recommends that the Australian Taxation Office review its compliance activity in relation to Work Related Expenses. The fact that \$100 million of abuse was identified in a single year through a review of one in one thousand taxpayers suggests that there is considerable scope in this area.

Recommendation 5

- 2.135 The committee recommends that the Australian Taxation Office continue with technological development and progress on pre-filling of returns to support the implementation of the reform agenda and to simplify taxpayers' interaction with the tax system, with the eventual goal to minimise, and ultimately remove, the need for taxpayers to amend pre-filled returns.

Company income tax deductions

- 3.1 As is the case with individuals, businesses are subject to income tax based on their taxable income. If businesses are sole traders, or consist of partnerships or trusts, their tax liability is that of their owners. In contrast, companies are taxed at the corporate level. Australian shareholders receiving dividend income from the company receive a credit against their tax liability for the tax paid by the company.¹
- 3.2 In Australia, business expenditure is tax deductible if it has a valid connection to business activities.² Expenses incurred during the course of ordinary business activities are referred to as revenue expenses, which include interest on loans for the business. Revenue expenses are deductible in the same year in which they are incurred. Capital expenses, such as those relating to the purchase of buildings and other assets, are deducted over the longer term and the depreciation amount of an asset can be tax deductible each year over the course of a number of years.³
- 3.3 The committee was asked to examine options to simplify the company income tax system, focussing on broadening the base to fund reductions in marginal rates. Particular reference was made to the deductibility of interest incurred by businesses in deriving their income.

1 Treasury, *Submission 19*, p. 10.

2 A list of business tax deductions is at Appendix D.

3 Treasury, *Submission 19*, p. 10.

Interest deductibility

- 3.4 Under Australia's company income tax system, interest expense is tax deductible to the extent it is incurred in gaining or producing assessable income or for the operation of a business. As with other business deductions, the expense cannot be capital, private or domestic in nature.⁴
- 3.5 The deductibility of interest expense is provided for through the general provision for deductions in section 8-1 of the *Income Tax Assessment Act (1997)* (Cth), rather than a specific section for interest deductibility.⁵
- 3.6 Evidence provided by the Parliamentary Budget Office (PBO) shows that interest costs vary by company size and industry type, meaning that interest deductibility is more important to some companies than others. Table 3.1 shows company interest expenses by company size, based on annual turnover. In 2014-15, interest expenses claimed by all companies in their tax returns totalled \$42 billion, \$27 billion of which were claimed by 955 very large companies.⁶
- 3.7 Table 3.1 illustrates that, for very large companies, around 2.3 per cent of their total expenses claimed were interest deductions. In recent years, this proportion has declined. The PBO suggested this decrease may reflect a range of factors including a general cut in interest rates during this period.⁷
- 3.8 The PBO stated that in 2012-13, the largest interest expense claims, as a proportion of total claimed expenses, were in the rental, hiring and real estate services industry, and the electricity, gas, water and waste services industry, which were around 6.6 per cent of reported expenses.⁸ In absolute terms, the mining and manufacturing industries had the largest interest expenditure, 20 per cent and 15 per cent of total reported interest expenses, respectively.⁹
- 3.9 In regards to the finance and insurance industries, the PBO explained that these industries have high levels of interest expense, with interest comprising nearly 26 per cent of their total expenses as they 'are in the

4 Treasury, *Submission 19*, p. 10.

5 Law Council of Australia, *Submission 6*, p. 4.

6 Parliamentary Budget Office (PBO), *Submission 3 (25th Parliament)*, p. 2. The category of 'very large' company includes those with an annual company turnover of more than \$250 million.

7 PBO, *Submission 25*, p. 22.

8 PBO, *Submission 25*, p. 23.

9 PBO, *Submission 25*, p. 23.

business of borrowing and lending money', as such, interest expense is a 'working expense...rather than being a cost of financing'.¹⁰

Table 3.1 Company interest deductions by company size (turnover), 2013-14

Company turnover	Number of companies	Total interest expenses (\$m)	Percentage of total interest expenses claimed (%)	Total expenses (\$m)	Interest as a percentage of total expenses (%)
<\$2 million (micro)	676,431	3,494	8.2	189,284	1.8
<\$10 million (small)	56,405	2,624	6.2	221,834	1.2
<\$100 million (medium)	15,026	5,234	12.3	381,843	1.4
<\$250 million (large)	1,174	3,755	8.8	180,719	2.1
>\$250 million (very large)	955	27,383	64.4	1,207,601	2.3
Total (excluding finance and insurance)	749,991	42,490	100.0	2,181,281	1.9

Source Parliamentary Budget Office (PBO), *Submission 2 (45th Parliament)*, p. 2.

Significance of interest deductibility

3.10 The importance of allowing businesses to deduct their interest expenses for borrowings (including debt funded investments) was emphasised by a range of submitters. For example, the Law Council of Australia referred to interest deductibility as an 'essential component of a neutral tax system',¹¹ while the Australian Private Equity and Venture Capital Association (AVCAL) asserted that it plays a significant role in assisting business activity and economic growth.¹² Similarly, the Australian Bankers' Association (ABA) outlined the importance of maintaining low cost capital to the Australian economy through the deductibility of interest payments, stating that debt funding 'forms the basis upon which most consumers and businesses invest and grow'.¹³

3.11 AVCAL also explained that the importance of interest deductibility goes beyond financing business operations, stating that:

10 Mr Colin Brown, First Assistant Parliamentary Budget Officer, PBO, *Committee Hansard*, Canberra, 5 February 2016, p. 25.

11 Law Council of Australia, *Submission 6*, p. 2.

12 Australian Private Equity and Venture Capital Association Limited (AVCAL), *Submission 7*, p. 4.

13 Australian Bankers' Association (ABA), *Submission 4*, p. 1.

It is also routinely considered within the context of decision-making by investors on the merits of investing in a particular business. The availability of deductions for interest costs is therefore fundamental to the overall competitiveness of the Australian business sector.¹⁴

3.12 The Treasury noted that interest deductibility is important for new businesses operating with high levels of expenditure, stating that:

The ability for the business to borrow funds and deduct the interest and other expenditure against assessable income significantly benefits the business, provides an incentive for investment and positively impacts the economy. Without the ability to deduct the cost of expenditure, some profitable investments may happen in other jurisdictions or not at all.¹⁵

3.13 As the PBO noted, some businesses are more reliant on interest deductibility than others. Submitters asserted that specific sectors, such as financiers, property development and investment, and capital intensive industries, rely heavily on debt funding and interest deductibility.¹⁶

3.14 The Commercial Asset Finance Brokers Association of Australia (CAFBA), representing companies that assist businesses to finance the purchase of equipment, maintained that interest deductibility is a 'major incentive' for companies to invest in capital. It added that, in Australia, 'a significant proportion of all new equipment purchased by businesses is [debt] financed'.¹⁷

3.15 The Property Council of Australia referred to debt funding as 'critical to financing major property and infrastructure projects'.¹⁸ It argued that 'interest deductibility is a normal cost of business that creates income by encouraging investment'.¹⁹

3.16 The Minerals Council of Australia emphasised the importance of interest deductibility to the mining sector due to the sheer scale of funding mining

14 AVCAL, *Submission 7*, p. 2.

15 Treasury, *Submission 19*, p. 10.

16 See, for example: Australian Equipment Lessors Association (AELA) and the Australian Fleet Lessors Association (AFLA), *Submission 26*, p. 2; Commercial Asset Finance Brokers Association of Australia (CAFBA), *Submission 8*, p. 1; Property Council of Australia, *Submission 16*, p. 2; Minerals Council of Australia, *Submission 22*, p. 1.

17 CAFBA, *Submission 9*, p. 1.

18 Property Council of Australia, *Submission 16*, p. 1.

19 Property Council of Australia, *Submission 16*, p. 1.

projects require. It stated that Australia's mining industry 'relies heavily on highly mobile foreign capital, including debt funded capital'.²⁰

Integrity rules around interest deductibility: thin capitalisation and transfer pricing

- 3.17 From an international perspective, the rules determining what income is taxed and how tax is assessed varies from country to country. In this global context, to help address the challenges of base erosion and profit shifting (BEPS),²¹ most countries have integrity rules that apply to interest expense incurred through international transactions.²² Australia has comprehensive thin capitalisation rules and transfer pricing rules.²³ Other countries, including the United Kingdom²⁴ and New Zealand²⁵ also have integrity rules around these areas.
- 3.18 Australia's thin capitalisation rules aim to prevent excessive debt funding by disallowing interest deductions if the underlying debt exceeds certain limits.²⁶ The three tests used to determine the allowable level of debt deductions are:
- the 'arm's length' debt test, which benchmarks commercial or truly independent debt levels for the Australian operations;
 - the 'safe harbour test', which sets the rate of debt that an entity can use to fund its Australian operations; and
 - the 'worldwide gearing ratio test', which allows gearing of a company's Australian operations to be geared up to the level of the worldwide group.²⁷
- 3.19 The PBO provided an analysis of Australian Taxation Office (ATO) data on the interest expenses of multinational companies (excluding finance

20 Minerals Council of Australia, *Submission 22*, p. 1.

21 Base erosion and profit shifting refers to tax strategies adopted by companies with multinational arms to exploit gaps and mismatches in tax rules to artificially shift profits to low or no tax locations, thereby reducing the overall company tax paid.

22 Treasury, *Submission 19*, p. 11.

23 Treasury, *Submission 19*, p. 11.

24 K Nicholson and D Burn, *United Kingdom – Corporate Deductions*, Price Waterhouse Coopers (PWC) World Wide Tax Summaries, 1 May 2015, <<http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/United-Kingdom-Corporate-Deductions>>, accessed 20/1/2016.

25 D Lamb, *New Zealand – Corporate Deductions*, PWC World Wide Tax Summaries, 16 June 2015, <<http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/New-Zealand-Corporate-Deductions>>, accessed 20 January 2016.

26 Treasury, *Submission 19*, p. 11.

27 Treasury, *Submission 19*, p. 11.

- and insurance companies). It showed that in 2012-13, \$26 billion of interest deductions were subject to thin capitalisation rules (57 per cent of total interest deductions), \$20.6 billion of which related to 612 very large companies.²⁸
- 3.20 The PBO noted that companies that were subject to thin capitalisation rules in 2012-13 had, on average, higher relative interest expenses (3.2 per cent) than for all companies (2.3 per cent) and companies not subject to the rules (1.6 per cent).²⁹
- 3.21 It is to be noted that this data is based on the thin capitalisation rules as they were before significant changes were made in 2014, which first applied to companies from 1 July 2014. One of the major changes was the reduction of the statutory safe harbour debt limit for general entities from 75 per cent debt-to-assets to 60 per cent debt-to-assets (or from 3:1 to 1.5:1 on a debt-to-equity basis).³⁰
- 3.22 Australia's transfer pricing rules dictate that pricing for international dealings between related parties reflect what is expected from unrelated parties operating at arm's length. These rules can impact on interest expenses arising from related party transactions, since the interest charged on loans needs to be charged at the rate expected to be charged by unrelated parties (i.e. on an 'arm's length' basis).³¹
- 3.23 Australia updated its transfer pricing rules in 2012 and 2013 to be more consistent with the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines.³²
- 3.24 In April 2017, the Government's Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 passed both Houses. According to The Treasury, the Bill updates Australia's transfer pricing rules to reference the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, as amended by the BEPS Actions 8-10 (transfer pricing and value creation) recommendations. The update applies from income years commencing on or after 1 July 2016.³³
- 3.25 The Treasury stated:

28 PBO, *Submission 25*, p. 23.

29 PBO, *Submission 25*, p. 23.

30 *Tax and Superannuation Laws Amendment (2014 Measures No. 4) Act 2014* (Cth).

31 Treasury, *Submission 19*, p. 12.

32 Treasury, *Submission 19*, p. 12; Treasury, *Income Tax: cross-border profit allocation – review of transfer pricing rules consultation paper*, February 2016, p. 1.

33 Treasury, *Submission 2 (45th Parliament)*, p. 1.

Incorporation of the OECD Guidelines update will, amongst other things, ensure the pricing of transactions reflects the economic substance of the transaction rather than just the contractual form. For example, it will ensure the interest rates attributed to related party loans reflect the actual commercial risks assumed.³⁴

- 3.26 A number of submitters acknowledged the importance of existing integrity measures.³⁵ For example, AVCAL asserted that there is no evidence of excessive leverage as a consequence of interest deductibility and that current safeguards are adequate.³⁶
- 3.27 Similarly, the Business Council of Australia asserted that the thin capitalisation regime aims to ‘strike a balance between integrity and flexibility’ and that ‘the recent changes to Australia’s transfer pricing and thin capitalisation laws make these regimes arguably the most robust in the world’.³⁷
- 3.28 While expressing general support for Australia’s thin capitalisation and transfer pricing rules, AVCAL stressed the need for business and investor certainty. AVCAL was critical of recent changes made to thin capitalisation rules, arguing that a lack of transitional arrangements had forced some businesses to restructure their financing operations, at significant cost.³⁸
- 3.29 In contrast, the Tax Justice Network Australia (TJN) was critical of Australia’s current approach to thin capitalisation, asserting that it allows ‘companies to artificially debt load up to the debt-to-equity safe harbour’.³⁹ The TJN contended that this ‘effectively sets a safe limit on the acceptable amount of tax avoidance a multinational enterprise can enter into without facing challenge’.⁴⁰ The TJN made several recommendations to restrict artificial debt loading which are outlined later in this chapter.
- 3.30 The ATO indicated in relation to debt, that while every jurisdiction has integrity challenges, it felt it had ‘the tools to enforce the policy settings

34 Treasury, *Submission 2 (45th Parliament)*, p. 1.

35 See, for example: ABA, *Submission 4*, p. 2; Australian Petroleum Production and Exploration Association (APPEA), *Submission 8*, p. ii.

36 AVCAL, *Submission 7*, p. 4.

37 Business Council of Australia, *Submission 21*, p. 6.

38 AVCAL, *Submission 7*, p. 2.

39 Tax Justice Network Australia (TJN), *Submission 18*, p. 13.

40 TJN, *Submission 18*, p. 13.

which are in place'.⁴¹ As an example of the application of these tools, the ATO noted its successful action in relation to transfer pricing against Chevron in the Federal Court in October 2015,⁴² as well as its successful action against Orica in the Federal Court in December 2015, where '[P]art IVA [of the *Income Tax Assessment Act 1936* (Cth)]...the general anti-avoidance rule applied... to artificial creation of deductible debt'.⁴³

OECD base erosion and profit shifting recommendations

Thin capitalisation rules

3.31 Chartered Accountants Australia and New Zealand (Chartered Accountants ANZ) drew the committee's attention to the G20/OECD BEPS recommendations⁴⁴ that were released in October 2015 as part of the BEPS Action Plan, summarising the BEPS recommendation in relation to limiting interest deductions (Action Item 4) as follows:

Broadly, the OECD recommends a fixed ratio rule which limits an entity's net interest deductions to a fixed percentage of its profits, measured using earnings before interest, taxes, depreciation and [amortisation] (EBITDA) based on tax numbers. The percentage restriction should be set by each jurisdiction at a single benchmark fixed ratio of between 10 [per cent] and 30 [per cent] of EBITDA.⁴⁵

3.32 Chartered Accountants ANZ further described that 'the use of EBITDA reflects policy thinking that links interest deductions to the level of the entity's taxable economic activity and, comparatively speaking, the fixed ratio rule has the advantage of greater simplicity'.⁴⁶ However, it noted that 'any decision to link net interest deductions to the level of an entity's EBITDA will need to address volatility in earnings'.⁴⁷

41 Mr Jeremy Hirschhorn, Deputy Commissioner, ATO, *Committee Hansard*, Canberra, 5 February 2016, p. 32.

42 Mr Jeremy Hirschhorn, ATO, *Committee Hansard*, Canberra, 5 February 2016, p. 31; *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* (No 4) [2015] FCA 1092.

43 Mr Jeremy Hirschhorn, ATO, *Committee Hansard*, Canberra, 5 February 2016, p. 31; *Orica Limited v Commissioner of Taxation* [2015] FCA 1399.

44 The recommendations are available in the report: Organisation for Economic Co-operation and Development (OECD), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Final Report*, October 2015.

45 Chartered Accountants Australia and New Zealand (Chartered Accountants ANZ), *Submission 11*, p. 13.

46 Chartered Accountants Australia and New Zealand (Chartered Accountants ANZ), *Submission 11*, p. 13.

47 Chartered Accountants Australia and New Zealand (Chartered Accountants ANZ), *Submission 11*, p. 14.

- 3.33 Chartered Accountants ANZ emphasised that if the proposed fixed ratio range was implemented, 87 per cent of the companies studied by the OECD would be able to deduct all of their net third party interest costs. The group suggested that this model, if implemented, could create tax competition between nations, whereby a nation could assume a higher fixed ratio with more lenient interest deductibility rules in order to attract international investment.⁴⁸ These potential tactics, Chartered Accountants ANZ noted, highlight the need for ‘a multi-lateral approach to implementing the OECD recommendations’.⁴⁹
- 3.34 The OECD also recommended an optional fall-back rule whereby, according to Chartered Accountants ANZ, ‘an entity with net interest expense above a country’s fixed ratio [could] deduct interest up to the level of net third party interest/EBITDA ratio of its worldwide group’.⁵⁰ This would potentially be subject to a cap of 100 per cent of total group interest; however nations could apply an uplift of up to 10 per cent to prevent double taxation.⁵¹
- 3.35 Whilst Australia’s rules are premised on the proportion of debt as compared to the assets of the entity rather than net interest as compared to EBITDA, in evidence to the committee, the Treasury explained that the OECD’s final report had made allowance for Australia’s rules, where countries ‘for their own specific reasons, may decide to continue with a debt-to-asset treatment’, as well as the arm’s length debt test.⁵² These settings are required as Australia’s circumstances involve ‘relatively high corporate rates internationally, high infrastructure investment needs, resource rich, and [we are] pretty reliant on foreign capital’.⁵³ AVCAL cited the Board of Taxation’s Review of the Arm’s Length Debt Test (2014) which had highlighted the importance of the arm’s length debt test, particularly for taxpayers that are ‘generally of the kind that contributes significant economic activity within the services, resources and infrastructure industries’.⁵⁴

48 Chartered Accountants ANZ, *Submission 11*, p. 13.

49 Chartered Accountants ANZ, *Submission 11*, p. 14.

50 Chartered Accountants ANZ, *Submission 11*, p. 14.

51 Chartered Accountants ANZ, *Submission 11*, p. 14.

52 Mr Rob Heferen, Deputy Secretary, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 33.

53 Mr Rob Heferen, Deputy Secretary, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 33.

54 AVCAL, *Submission 7*, p. 3; Board of Taxation, *Review of the Thin Capitalisation Arm’s Length Debt Test*, 2014, pp. 5-6.

- 3.36 Chartered Accountants ANZ made a similar comparison between Australia's rules and the OECD's approach, stating that overall, 'Australia's current thin capitalisation regime already has many of the hallmarks of the OECD's *flexible* approach to limiting interest deductions'.⁵⁵ In addition, it warned that as the current stage in the BEPS process involves monitoring the reactions of governments around the world, 'it would be unwise for Australia to be a "first mover" in implementing the OECD recommendations'.⁵⁶
- 3.37 The Treasurer responded to the release of the OECD recommendations in October 2015, stating that:
- ...the Government will be consulting with stakeholders, foreign governments and the OECD and will pay close attention to ensuring investment activity is not compromised and that Australia remains an economically competitive place to do business.⁵⁷
- 3.38 The Treasury noted that it is currently considering the recommendations alongside the impact of the 2014 changes to the thin capitalisation rules,⁵⁸ and that a process will be undertaken to ensure that Australia's rules 'do not allow companies to have quite a departure from the base of the 30 per cent EBITDA under reasonable assumptions'.⁵⁹

Anti-hybrid rules

- 3.39 The TJN expressed concern about whether Australia was doing enough to counter hybrid mismatch arrangements.⁶⁰ Hybrid mismatch arrangements are arrangements that 'exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral'.⁶¹
- 3.40 In 2015, the OECD, as part of the BEPS Action Plan, released its final report on Action Item 2, *Neutralising the Effects of Hybrid Mismatch*

55 Chartered Accountants ANZ, *Submission 11*, p. 16.

56 Chartered Accountants ANZ, *Submission 11*, p. 17.

57 The Hon. Scott Morrison MP, Treasurer, 'OECD report supports Australian Government action on multinational tax avoidance', *Media Release*, 6 October 2015.

58 Treasury, *Submission 19*, p. 11.

59 Mr Rob Heferen, Deputy Secretary, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 33.

60 Dr Mark Zirnsak, Spokesperson, TJN, *Committee Hansard*, Canberra, 5 February 2016, p. 30.

61 Organisation for Economic Co-operation and Development (OECD), Base Erosion and Profit Shifting Project (BEPS), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - Final Report*, 2015, p. 11.

Arrangements. The report makes recommendations regarding the design of domestic rules and the development of model treaty provisions that would neutralise the tax effects of hybrid mismatch arrangements.⁶²

3.41 In the 2017-17 Budget, the Government announced that it will implement the OECD's recommendations. The Treasury explained:

Under the new rules to neutralise hybrid mismatch outcomes, Australia will deny a tax deduction if the offshore related party receiving the payment is not taxed on the income. Similarly, if a tax deduction is not denied to an offshore related party in relation to a payment to an Australian entity which would otherwise not be taxed in Australia, the income received in Australia will be taxed.⁶³

Arguments for retaining interest deductibility

3.42 The importance of retaining interest deductibility within the company income tax system was highlighted by a range of stakeholders, with the main themes being that:

- removing interest deductibility would negatively impact on investment and the Australian economy;
- interest deductibility in Australia is consistent internationally, and its removal would undermine the competitiveness of Australian companies; and
- Australia needs to reduce its corporate tax rate, however the corporate tax system alone cannot fund this reduction.

Impact on investment and the Australian economy

3.43 One of the more common criticisms of the idea of removing interest deductibility was that it would have far-reaching, negative consequences for investment and the Australian economy as a whole due to the increase in the cost of obtaining debt funding. For example, the Law Council of Australia argued that removing the existing tax deductibility for businesses 'would result in a reduction in investment, job creation and economic growth'⁶⁴ and KPMG argued it would 'create its own distortions and detrimental disincentives'.⁶⁵

62 OECD, BEPS, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - Final Report*, 2015, p. 11.

63 Treasury, *Submission 2 (45th Parliament)*, p. 1.

64 Law Council of Australia, *Submission 6*, p. 2.

65 KPMG, *Submission 10*, p. 4.

- 3.44 The ABA was concerned that removing interest deductibility would undermine the competitiveness of Australian banks, and carry wide-ranging risks to the Australian economy.⁶⁶ It stressed that 'Australia has traditionally been a net importer of capital and this capital has been used to help fund the development of the Australian economy', and argued that if interest deductibility was removed, and companies could not claim deductions on debt funding, 'it could act as a brake on domestic investment and adversely affect economic growth'.⁶⁷
- 3.45 Similarly, CSL Limited warned that such a change would 'further disincentivise growth and productivity by increasing the cost of debt financed investment and reducing the incentive for investment by Australian companies'.⁶⁸
- 3.46 AVCAL argued that removing interest deductibility would be bad for investment and the Australian economy, because it would result in higher borrowing costs for Australian companies and 'hinder their capacity to fund further expansion, innovation and job creation'.⁶⁹ AVCAL stressed that debt funding helps companies to attract capital and invest in new technologies, and that removing interest deductibility would have a 'negative effect on the ability of start-ups to attract funding'.⁷⁰ To support its arguments, it noted modelling by Ernst and Young for the United States economy, which showed that limiting interest deductions to fund corporate tax reductions would reduce net economic growth in the long term.⁷¹
- 3.47 CAFBA reiterated this argument, observing that it would be difficult for Australia to encourage new start-ups and the growth of existing businesses if 'borrowing costs and equipment financing is more expensive'.⁷² It added that lowering tax rates would be meaningless for start-up businesses as they rarely produce sufficient income in the first few years. As a result denying interest deductibility 'would be a huge disincentive to start a new business, in many cases making it not viable'.⁷³
- 3.48 Concerns about removing interest deductibility were raised by representatives across diverse industries. The Housing Industry
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66 ABA, *Submission 4*, p. 2.

67 ABA, *Submission 4*, p. 1.

68 CSL Limited, *Submission 5*, p. 1.

69 AVCAL, *Submission 7*, p. 2.

70 AVCAL, *Submission 7*, p. 2.

71 AVCAL, *Submission 7*, p. 2.

72 CAFBA, *Submission 9*, p. 2.

73 CAFBA, *Submission 9*, p. 2.

Association argued that removing tax deductibility would have a negative effect on the housing industry, and warned that it would increase the cost of capital and 'force a reduction in the supply of new housing'.⁷⁴

3.49 The Minerals Council of Australia argued that removing interest deductibility would:

...reduce the rate of return for investments in Australia and impact on the attractiveness of Australia as a destination for investment for capital intensive resource and infrastructure projects. Fewer resource investment projects would be profitable at the margin and there would be a corresponding decline in investment. Lower investment would in turn reduce productivity and wages and economic growth. The effective rate of tax would increase for many investments in capital intensive industries, even if the headline corporate rate was reduced.⁷⁵

3.50 CAFBA envisaged negative consequences on equipment purchases by businesses if interest deductibility was removed, with the flow-on effects being 'clearly enormous, as it affects not only the businesses that need the equipment, but also those who supply and service it'.⁷⁶ It outlined that:

- businesses would lose their interest deductions in borrowing to purchase equipment;
- it would require lenders to 'substantially increase' interest rates to customers to compensate for the removal of their interest deductions; and
- it would increase the cost of equipment because equipment suppliers would 'also be denied interest deductions on the borrowing to hold stock and finance inventory'.⁷⁷

International consistency and competitiveness

3.51 A range of submitters highlighted that interest deductibility was common internationally, and that Australian companies would be disadvantaged if the deduction was removed. For example, the Law Council of Australia noted that the deductibility of interest by businesses in Australia is consistent with similar jurisdictions, and asserted that any reform 'would carry significant risks such as costly restructuring for companies'.⁷⁸

74 Housing Industry Association, *Submission 13*, p. 3.

75 Minerals Council of Australia, *Submission 22*, p. 8.

76 CAFBA, *Submission 9*, p. 1.

77 CAFBA, *Submission 9*, p. 1.

78 Law Council of Australia, *Submission 6*, p. 4.

- 3.52 Similarly, the ABA stressed that most OECD countries allow interest deductibility and that if Australia removed the deduction, it would mean inconsistency amongst OECD countries and uncertainty for businesses.⁷⁹ The ABA took the view that 'taking unilateral action to deny interest deductions would be contrary to global best practice and mean that Australia's tax policy direction would become isolated from that of most other countries'.⁸⁰
- 3.53 Ernst and Young argued that changes of this nature to Australia's tax rules would make Australian companies uncompetitive because they would have to pay higher taxes unless they were able to replace their debt with equity. It warned that companies that currently used debt would be disadvantaged in comparison to domestic competitors using less debt, such as those with larger financial resources, and companies overseas who are advantaged by interest deductibility in their home countries.⁸¹
- 3.54 Ernst and Young added that Australian companies would need to undergo significant transitional arrangements to remain competitive, and could only replace their debt by selling assets, raising new capital or implementing 'cost reduction programs to free up cash flow'.⁸² It warned that such transitional arrangements would be significant in terms of the costs of winding back debt programs, would 'take time and would add to volatility'.⁸³

Corporate tax system alone cannot fund corporate tax cuts

- 3.55 As outlined in Chapter One, the 2012 Business Tax Working Group concluded that although Australia should continue the trend from the late 1980s to lower the company tax rate, there was a lack of support in the business community for measures to broaden the business tax base to fund a company tax rate reduction.⁸⁴
- 3.56 This view that the corporate tax system was not capable of self-funding a corporate tax cut was reiterated among roundtable participants and submitters.⁸⁵ In arguing this point, Ernst and Young noted that Australia's

79 ABA, *Submission 4*, p. 2.

80 ABA, *Submission 4*, p. 2.

81 Ernst and Young, *Submission 12*, p. 7.

82 Ernst and Young, *Submission 12*, pp. 7-8.

83 Ernst and Young, *Submission 12*, p. 8.

84 Business Tax Working Group, *Final Report*, November 2012, p. iii; See also, Mr Rob Heferen, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 29.

85 See for example, Mr Tony Pearson, Chief Economist and Executive Director, ABA, *Committee Hansard*, Canberra, 5 February 2016, p. 28; Mr Alf Capito, Partner, Ernst and Young, *Committee Hansard*, Canberra, 5 February 2016, p. 29; Ernst and Young, *Submission 12*, p. 4.

corporate tax base has been broadened since 2012 through more extensive transfer pricing and thin capitalisation rules, and restrictions on research and development claims for companies with large turnovers.⁸⁶

3.57 Similarly, CSL Limited questioned the value of broadening the base of company income taxes in this way, asserting that 'headline reductions funded by increases elsewhere to the same parties would likely result in a nil net benefit to the nation'.⁸⁷

3.58 This sentiment was supported by KPMG, who asserted that any benefits from any trade-off between base broadening and rate cuts would be 'impressionistic only, with a lower headline rate for company tax, but the same effective tax rate'.⁸⁸

3.59 The Minerals Council of Australia argued that a revenue neutral cut to the corporate tax rate, funded by removing interest deductibility, would not reduce effective tax rates:

Whilst the impact on the overall revenue might be neutral, a change of this nature would effectively result in the redistribution of the incidence of company taxation to industries which rely more heavily on debt funding such as capital-intensive industries. Such a proposal would not represent tax reform and would be counter to Australia's tax policy imperatives to increase investment and growth.⁸⁹

3.60 INPEX emphasised that while there has been a global trend in reducing corporate tax rates, many of the countries that have reduced their rates have not undertaken a 'base-rate trade off'. INPEX argued that consideration be given 'as to whether base broadening to fund a cut will actually help competitiveness given the tax regimes of competitor countries still include a number of concessional treatments'.⁹⁰

3.61 While not commenting specifically on the Australian system, the United Kingdom's (UK) Office of Tax Simplification noted some of its preliminary findings on changes to the tax system in the UK, including that, following the reduction of corporation tax rates in the UK, the value of many business deductions (tax reliefs) has reduced.⁹¹

86 Ernst and Young, *Submission 12*, p. 4.

87 CSL Limited, *Submission 5*, p. 1.

88 KPMG, *Submission 10*, p. 5.

89 Minerals Council of Australia, *Submission 22*, p. 1; See also Mr James Sorahan, Director, Tax, Minerals Council of Australia, *Committee Hansard*, Canberra, 5 February 2016, p. 35.

90 INPEX, *Submission 17*, p. 4.

91 Office of Tax Simplification, *Submission 3*, p. 4.

Arguments for reforming company income tax deductions

- 3.62 In evidence to the committee, most stakeholders argued against the need to reform company income tax deductions. However the Australian Council of Social Service (ACOSS) asserted that some business tax concessions could be removed,⁹² and the TJN recommended that integrity rules be strengthened.⁹³
- 3.63 ACOSS was generally critical of current business tax concessions, asserting that concessions should be removed in favour of cuts to company tax rates. It stated that:
- Business tax concessions distort investment decisions between different industries or activities in economically harmful ways and, their removal should make room for lower company tax rates and an improvement in economic efficiency, without loss of public revenue.⁹⁴
- 3.64 The TJN put forward the view that deductions for interest repayments, ‘especially in relation to interest repayments made to another part of the same corporation located overseas, should be curtailed’.⁹⁵ It argued that Australia’s current rules in relation to thin capitalisation were being exploited through ‘aggressive tax structures’ that allow profits to be shifted.⁹⁶
- 3.65 The TJN argued that there were a number of ways that rules could be tightened to address profit shifting through the use of interest deductibility,⁹⁷ for example:
- in relation to the thin capitalisation rules, replacing the current arm’s length and safe harbour tests with solely a worldwide gearing ratio test;
 - introducing legislation to disallow ‘deductions for transactions with resident entities of a jurisdiction that does not effectively exchange information with the ATO’; and
 - introducing legislation giving effect to the anti-hybrid rules.⁹⁸
- 3.66 In response to this, the Treasury highlighted the recent tightening of Australia’s thin capitalisation rules as well as the work currently being

92 Australian Council of Social Service (ACOSS), *Submission 24*, p. 3.

93 TJN, *Submission 18*, p. 1.

94 ACOSS, *Submission 24*, p. 3.

95 TJN, *Submission 18*, p. 1.

96 TJN, *Submission 18*, p. 4.

97 Dr Mark Zirnsak, Spokesperson, TJN, *Committee Hansard*, Canberra, 5 February 2016, p. 30.

98 TJN, *Submission 18*, p. 1.

undertaken by the Government regarding the G20/OECD BEPS recommendations, which includes consultation on aligning Australia's transfer pricing rules more closely to the OECD recommendations and on implementation of anti-hybrid rules (as discussed above).⁹⁹

Conclusions

- 3.67 In reviewing the evidence on options to simplify the company income tax system, specifically to broaden the base to fund reductions in marginal tax rates, it was clear to the committee that there is no appetite for change, particularly in relation to the deductibility of interest incurred by businesses in deriving their income.
- 3.68 Given the importance of interest deductibility to Australian businesses, and the potentially significant negative effects that may result from change to deductibility arrangements, particularly in relation to investment and the Australian economy, the committee is strongly of the view that current arrangements should be retained.
- 3.69 The committee notes the findings of the Business Tax Working Group in regards to the difficulty of identifying measures to further broaden the company tax base since reductions in the company tax rate during the 1980s and 1990s were already funded by a range of measures broadening the company tax base.¹⁰⁰
- 3.70 The committee also notes the significant work currently being undertaken by the Government on the implementation of the G20/OECD BEPS recommendations. This work will assist to strengthen Australia's already robust rules addressing tax integrity.

99 Ms Kathryn Davy, Principal Adviser, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 30; Mr Rob Heferen, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 30.

100 Business Tax Working Group, *Final Report*, November 2012, p.10.

Recommendation 6

- 3.71 The committee recommends that the Government maintain the current company income tax framework that allows the deductibility of interest incurred by businesses in deriving their income.

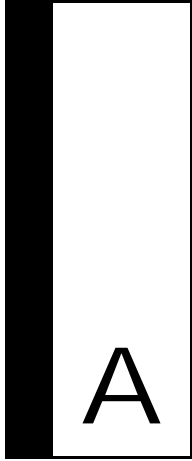
Recommendation 7

- 3.72 The committee recommends that the Government continue its important work on the implementation of the G20/OECD Base Erosion and Profit Shifting (BEPS) recommendations to further strengthen Australia's rules addressing tax integrity.

David Coleman MP

Chair

14 June 2017



Appendix A – List of Submissions

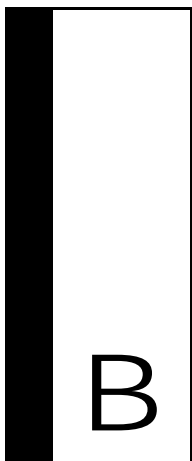
44th Parliament

- 1 Research Australia
- 2 ADJ Consultancy Services
- 3 Office of Tax Simplification
- 4 Australian Bankers' Association
- 5 CSL Limited
- 6 Law Council of Australia
- 7 Australian Private Equity and Venture Capital Association Limited
- 8 Australian Petroleum Production and Exploration Association
- 9 Commercial Asset Finance Brokers Association of Australia
- 10 KPMG
- 11 Chartered Accountants Australia and New Zealand
- 12 Ernst and Young
- 13 Housing Industry Association
- 14 Australian Financial Markets Association
- 15 Australian Chamber of Commerce and Industry
- 16 Property Council of Australia
- 17 INPEX
- 18 Tax Justice Network Australia
- 19 The Treasury
- 20 Mr Richard Highfield

- 21 Business Council of Australia
- 22 Minerals Council of Australia
- 23 Corporate Tax Association
- 24 Australian Council of Social Service
- 25 Parliamentary Budget Office
- 26 Australian Equipment Lessors Association and Australian Fleet Lessors Association
- 27 Australian Finance Conference
- 28 Master Builders Australia
- 29 H&R Block
- 30 Mr Raoul Dunk
- 31 Mr Christopher Moore
- 32 CPA Australia
- 33 Grattan Institute

45th Parliament

- 1 Australian Taxation Office
- 2 The Treasury
- 3 Parliamentary Budget Office



Appendix B – Hearings and witnesses

Friday, 5 February 2016 — Canberra

Australian Bankers' Association

Mr Tony Pearson, Chief Economist and Executive Director, Industry Policy

Mr Michael Barbour, General Manager, Group Tax, Westpac Banking Group

Australian Council of Social Service

Mr Peter Davidson, Senior Adviser

ADJ Consultancy Services

Mr Adam Johnston, Proprietor

Australian Chamber of Commerce and Industry

Mr Tim Hicks, Senior Manager, Economics and Industry Policy

Australian Financial Markets Association

Mr Rob Colquhoun, Director, Policy

Australian Petroleum Production and Exploration Association

Mr Noel Mullen, Deputy Chief Executive

Miss Anthea McKinnell, Vice President Treasury and Taxation, Woodside Energy

Australian Private Equity and Venture Capital Association

Mr Yasser El-Ansary, Chief Executive Officer

Australian Taxation Office

Ms Alison Lendon, Deputy Commissioner, Individuals

Mr Jeremy Hirschhorn, Deputy Commissioner, Public Groups and International

Mr Adam Kendrick, Assistant Commissioner, Individuals

CPA Australia

Mr Paul Drum, Head of Policy

Chartered Accountants Australia and New Zealand

Mr Matthew Hayes, Tax Consultant

Commercial Asset Finance Brokers Association of Australia

Mr David Gandolfo, President

Mrs Kathryn Bordonaro, Vice President

Ernst and Young

Mr Alf Capito, Australian and Asia-Pacific Tax, Partner

Housing Industry Association

Mr Graham Wolfe, Chief Executive, Industry Policy and Media

Institute of Public Accountants

Mr Tony Greco, General Manager Technical Policy

KPMG

Mr Grant Wardell-Johnson, Partner, Australian Tax Centre

Ms Faith Lu, Senior Consultant, Australian Tax Centre

Law Council of Australia

Mr Adrian Varrasso, Taxation Committee Chairman, Business Law Section

Master Builders Australia

Mr Wilhelm Harnisch, Chief Executive Officer

Mr Shaun Schmitke, National Director Industrial Relations

Minerals Council of Australia

Mr James Sorahan, Director, Tax

Parliamentary Budget Office

Mr Colin Brown, First Assistant Parliamentary Budget Officer, Budget Analysis Division

Mr Anthony McDonald, Assistant Parliamentary Budget Officer, Revenue Analysis Branch

Ms Stephanie Bowles, Assistant Director, Employment Taxes Unit

Mr Phillip Hawkins, Acting Director, Revenue Analysis Branch

Property Council of Australia

Mr Ken Morrison, Chief Executive

Ms Belinda Ngo, Director of Tax Policy

Research Australia

Mr Greg Mullins, Head of Policy

The Treasury

Mr Rob Heferen, Deputy Secretary, Revenue Group

Ms Kathryn Davy, Principal Adviser, Revenue Group

Mr Michael Quinlivan, Analyst, Revenue Group

Mr Bede Fraser, Principal Adviser, Individuals and Indirect Tax Division, Revenue Group

Ms Renata Swierkot, Analyst, Revenue Group

Tax Justice Network Australia

Dr Mark Zirnsak, Spokesperson

Mr Jason Ward, Spokesperson

Private Capacity

Mr Richard Highfield

Wednesday, 19 March 2017 —Canberra**Australian Taxation Office**

Ms Alison Lendon, Deputy Commissioner, Individuals

Ms Emma Rosenzweig, Acting Deputy Commissioner, Small Business

Mr Greg Williams, Deputy Commissioner, Smarter Data Program

Ms Erin Holland, Deputy Commissioner, Tax Practitioner, Lodgement Strategy and Engagement Support

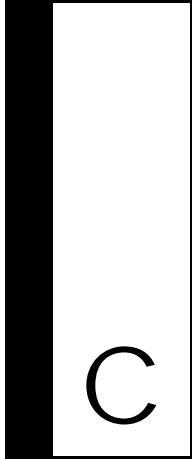
The Treasury

Ms Maryanne Mrakovcic, Deputy Secretary, Revenue Group

Ms Katherine Davy, Principal Adviser, Corporate and International Tax Division

Mr Brendan McKenna, Senior Adviser, Corporate and International Tax Division

Mr Bede Fraser, Principal Advisor, Individuals and Indirect Tax Division



Appendix C –Parliamentary Budget Office,
Response to Budget Analysis Request:
Personal Income Tax Deductions,
7 April 2016



Parliament of Australia
Parliamentary Budget Office

RESPONSE TO BUDGET ANALYSIS REQUEST – OUTSIDE THE CARETAKER PERIOD

Name of request:	Personal income tax deductions
Summary of request:	<p>The request sought information on personal income tax deductions including:</p> <ul style="list-style-type: none"> • Request 1 – the total value of selected personal income tax deductions (<u>Attachment A</u>) and estimates of the revenue forgone from these personal income tax deductions (<u>Attachment B</u>), in each year of the 2015-16 Budget forward estimates period. <ul style="list-style-type: none"> - The revenue forgone estimates are presented as both their dollar value and as a proportion of total forecast personal income tax collections in the year. - Attachment B also includes estimates of the average effective marginal tax rate for each category of deduction. • Request 2 - a breakdown of total work related expenses for 2012-13 by occupation (<u>Attachment C</u>) and by state and territory (<u>Attachment D</u>).
Person/party requesting analysis:	Mr David Coleman MP, Member for Banks
Date request received:	22 March 2016
Date response provided:	7 April 2016
Did the applicant ask for the request to be confidential?	Yes
Expiry date for the analysis:	Release of the next economic and fiscal outlook report

Overview

For request 1, this analysis is considered to be of **medium reliability** as it is based on detailed administrative data from 2012-13 and estimated for the 2015-16 Budget forward estimates period. The estimates are sensitive to assumptions around growth in taxpayers, income, and deductions over the 2015-16 Budget forward estimates period.

For request 2, this analysis is considered to be of **medium to high reliability** as it is based on a weighted 16 per cent sample of detailed administrative data from 2012-13. The analysis may differ to analysis based on a 100 per cent file of the same data, particularly for categories and deduction items based on a relatively small sample size.

RESPONSE TO BUDGET ANALYSIS REQUEST – OUTSIDE THE CARETAKER PERIOD

Methodology

Request 1

- The value of deductions, number of taxpayers and revenue forgone¹ was estimated based on a 16 per cent sample of de-identified personal income tax returns for 2012-13 based on current policy settings, assumptions, forecasts and projections consistent with the 2015-16 Mid-Year Economic and Fiscal Outlook (MYEFO).
- The average effective marginal tax rate for each deduction was calculated by dividing the revenue forgone associated with the deduction by the value of the deduction.
- Estimates have been rounded to the nearest \$10 million and 1,000 taxpayers.

Request 2

- The values were estimated based on a 16 per cent sample of de-identified personal income tax returns for 2012-13.
- Estimates have been rounded to the nearest \$1 million.

Data sources

- De-identified 16 per cent sample of personal income tax returns from the 2012-13 tax year, Australian Taxation Office (extracted on 2 February 2015²).
- 2015-16 MYEFO, Australian Government.

¹ For a detailed discussion of revenue forgone estimates, refer to the 2015 Tax Expenditures Statement.

² The data for the 2012-13 income year used in this analysis may differ from that published in the ATO's *Taxation Statistics 2012-13* publication as the PBO analysis uses more recent data (taking account of additional tax returns and/or amendments). Sample weights may also affect population estimates.

**RESPONSE TO BUDGET ANALYSIS REQUEST
– OUTSIDE THE CARETAKER PERIOD**

ATTACHMENT A – REQUEST 1 – PERSONAL INCOME TAX DEDUCTIONS

Table A1 presents selected personal income tax deductions in each year of the 2015-16 Budget forward estimates period, by financial year assessed.

Table A1: Personal income tax deductions - total, 2015-16 to 2018-19

	2015-16		2016-17		2017-18		2018-19	
	Number	\$m	Number	\$m	Number	\$m	Number	\$m
Work-related expenses ^(a)	9,358,000	23,270	9,471,000	24,170	9,591,000	25,190	9,717,000	26,330
Personal superannuation contributions	216,000	3,410	219,000	3,480	222,000	3,550	226,000	3,620
Cost of managing tax affairs	6,915,000	2,860	7,011,000	3,030	7,111,000	3,240	7,216,000	3,450
Gifts or donations	5,042,000	2,780	5,112,000	2,960	5,187,000	3,170	5,263,000	3,400
Dividends deductions	298,000	1,450	303,000	1,560	308,000	1,630	314,000	1,710
Interest deductions	410,000	830	417,000	830	423,000	870	431,000	910
Other deductions ^(b)	1,082,000	2,260	1,097,000	2,400	1,112,000	2,550	1,128,000	2,720
Total deductions^(c)	11,525,000	36,860	11,678,000	38,420	11,841,000	40,200	12,011,000	42,140

(a) Work related expenses include car-related expenses, travel expenses, clothing expenses, self-education expenses and other work related expenses.

(b) Low value pool deduction, deductible amount of undeducted purchase price of a foreign pension or annuity, deduction for project pool, forestry managed investment scheme deductions, election expenses and other deductions.

(c) The total number of taxpayers claiming deductions in each year does not equal the sum of the number claiming individual types of deduction, due to some taxpayers claiming more than one type of deduction.

**RESPONSE TO BUDGET ANALYSIS REQUEST
 – OUTSIDE THE CARETAKER PERIOD**

ATTACHMENT B – REQUEST 1 – PERSONAL INCOME TAX DEDUCTIONS, REVENUE FORGONE ESTIMATES

Table B1 presents estimates of the revenue forgone from selected personal income tax deductions in each year of the 2015-16 Budget forward estimates period, by year of collection. These estimates do not correspond to the values in table A1, which are based on the financial year assessed. In the context of tax deductions, collection is assumed to occur in the year following the financial year assessed.

The revenue forgone estimates represent the expected amount by which these deductions reduce personal income tax collections in the financial year (as such it shows existing utilisation). They are not an estimate of the financial impact of removing these personal income tax deductions. A costing of such a proposal would require consideration of the potential behavioural response of taxpayers to the removal of these deductions.

The revenue forgone estimate for 'all selected deductions' does not equal the sum of the revenue forgone estimates for all individual deductions. This is due to the interaction of the deductions and individuals' effective marginal tax rates.

Table B1: Revenue forgone from selected personal income tax deductions, 2015-16 to 2018-19

(\$m)	2015-16	2016-17	2017-18	2018-19
Work-related expenses ^(a)	8,400	8,370	8,740	9,050
Personal superannuation contributions	1,320	1,340	1,370	1,380
Cost of managing tax affairs	940	970	1,040	1,090
Gifts or donations	1,030	1,070	1,140	1,200
Dividends deductions	600	570	620	640
Interest deductions	350	300	300	310
Other deductions ^(b)	810	840	900	940
All selected deductions	13,490	13,510	14,160	14,670

(a) Work related expenses include car-related expenses, travel expenses, clothing expenses, self-education expenses and other work related expenses.

(b) Low value pool deduction, deductible amount of undeducted purchase price of a foreign pension or annuity, deduction for project pool, forestry managed investment scheme deductions, election expenses and other deductions.

**RESPONSE TO BUDGET ANALYSIS REQUEST
– OUTSIDE THE CARETAKER PERIOD**

Table B2 presents the estimates of the revenue forgone from selected personal income tax deductions as a proportion of total forecast personal income tax collections³ from the 2015-16 MYEFO.

Table B2: Revenue forgone from selected personal income tax deductions as a percentage of total individuals and other withholding tax revenue, 2015-16 to 2018-19

	2015-16	2016-17	2017-18	2018-19
Total personal income tax revenue (\$m)	193,360	204,790	218,750	234,750
Proportion of individuals and other withholding tax revenue (%)				
<i>Work-related expenses^(a)</i>	4.34	4.09	4.00	3.86
<i>Personal superannuation contributions</i>	0.68	0.65	0.63	0.59
<i>Cost of managing tax affairs</i>	0.49	0.48	0.47	0.47
<i>Gifts or donations</i>	0.53	0.52	0.52	0.51
<i>Dividends deductions</i>	0.31	0.28	0.28	0.27
<i>Interest deductions</i>	0.18	0.15	0.14	0.13
<i>Other deductions^(b)</i>	0.42	0.41	0.41	0.40
All selected deductions	6.97	6.60	6.47	6.25

(a) Work related expenses include car-related expenses, travel expenses, clothing expenses, self-education expenses and other work related expenses.

(b) Low value pool deduction, deductible amount of undeducted purchase price of a foreign pension or annuity, deduction for project pool, forestry managed investment scheme deductions, election expenses and other deductions.

³ Individuals and other withholding tax (2015-16 MYEFO, page 50)

**RESPONSE TO BUDGET ANALYSIS REQUEST
– OUTSIDE THE CARETAKER PERIOD**

Table B3 presents estimates of the average effective marginal tax rate for each category of deductions. The average effective marginal tax rates in the table represent the rate that applies to each dollar of personal income tax deduction.

Table B3: Personal income tax deductions – average effective marginal tax rate, 2015-16 to 2018-19

(%)	2015-16	2016-17	2017-18	2018-19
Work-related expenses ^(a)	36.1	34.6	34.7	34.4
Personal superannuation contributions	38.7	38.4	38.6	38.3
Cost of managing tax affairs	32.8	32.1	32.1	31.7
Gifts or donations	36.9	36.0	36.0	35.4
Dividends deductions	41.2	36.8	38.0	37.3
Interest deductions	42.6	36.8	34.9	34.3
Other deductions ^(b)	35.9	35.2	35.2	34.7
All selected deductions	36.6	35.2	35.2	34.8

(a) Work related expenses include car-related expenses, travel expenses, clothing expenses, self-education expenses and other work related expenses.

(b) Low value pool deduction, deductible amount of undeducted purchase price of a foreign pension or annuity, deduction for project pool, forestry managed investment scheme deductions, election expenses and other deductions.

**RESPONSE TO BUDGET ANALYSIS REQUEST
– OUTSIDE THE CARETAKER PERIOD**

ATTACHMENT C – REQUEST 2 – PERSONAL INCOME TAX DEDUCTIONS (BY OCCUPATION)

Table C1 presents selected income tax deductions by type by occupation of the individual taxpayer. The occupation categories presented are based on the ATO's Salary and Wage Occupation Codes 2013 (2-digits) available at <https://www.ato.gov.au/Forms/Salary-and-wage-occupation-codes-2013/>.

Table C1: Personal income tax deductions by occupation, 2012-13

(\$m)	Work-related expenses ^(a)	Personal superannuation contributions	Cost of managing tax affairs	Gifts or donations	Dividends deductions	Interest deductions	Other deductions ^(b)	Total
Apprentice or trainee	326	1	11	4	1	2	4	349
Arts and media professionals	206	5	17	17	5	3	11	263
Automotive and engineering trades workers	855	2	50	25	9	6	52	999
Business, human resource and marketing professionals	1,244	26	82	126	121	65	113	1,777
Carers and aides	531	4	37	30	12	4	11	629
Chief executives, general managers and legislators	926	76	241	346	145	201	186	2,121
Cleaners and laundry workers	166	3	18	10	2	1	5	205
Clerical and office support workers	89	3	10	9	3	2	5	121
Construction and mining labourers	619	3	30	13	3	4	16	688
Construction trades workers	753	3	36	11	4	4	35	846
Consultants	170	12	17	21	16	8	26	270
Design, engineering, science and transport professionals	947	13	84	93	77	41	100	1,356
Education professionals	1,202	40	83	114	36	22	53	1,549
Electro-technology and telecommunications	603	2	33	19	12	8	35	712

**RESPONSE TO BUDGET ANALYSIS REQUEST
- OUTSIDE THE CARETAKER PERIOD**

(\$m)	Work-related expenses ^(a)	Personal superannuation contributions	Cost of managing tax affairs	Gifts or donations	Dividends deductions	Interest deductions	Other deductions ^(b)	Total
trades workers								
Engineering, IT and science technicians	418	2	35	26	14	9	36	541
Factory process workers	225	2	24	18	2	3	11	285
Farm, forestry and garden workers	139	8	11	4	1	1	6	170
Farmers and farm managers	50	9	4	3	2	2	4	74
Food preparation assistants	46	..	5	3	1	57
Food trade workers	198	..	16	8	2	1	7	232
General clerical workers	323	31	47	46	18	18	22	505
Health and welfare support workers	251	1	14	14	3	1	10	295
Health professionals	1,410	75	114	160	72	55	197	2,084
Hospitality workers	140	2	15	9	2	2	4	174
Hospitality, retail and service managers	644	7	48	35	26	25	38	824
IT professionals	346	1	28	37	29	10	33	485
Inquiry clerks and receptionists	102	3	13	12	2	4	5	141
Legal, social and welfare professionals	341	17	34	59	14	17	28	510
Machine and stationary plant operators	375	1	29	18	5	5	30	462
Mobile plant operators	250	1	18	9	1	1	12	293
Numerical clerks	305	12	30	37	20	16	25	446
Office managers and program administrators	579	19	62	61	33	25	55	835
Other clerical and administrative workers	257	8	25	23	9	6	15	344

**RESPONSE TO BUDGET ANALYSIS REQUEST
– OUTSIDE THE CARETAKER PERIOD**

(S\$m)	Work-related expenses ^(a)	Personal superannuation contributions	Cost of managing tax affairs	Gifts or donations	Dividends deductions	Interest deductions	Other deductions ^(b)	Total
	Other labourers	4	22	13	3	3	11	381
	Other technicians and trades workers	2	19	12	4	4	13	310
	Personal assistants and secretaries	5	16	12	6	5	8	148
	Protective service workers	1	30	24	8	6	14	590
	Road and rail drivers	3	42	27	5	5	34	932
	Sales assistants and salespersons	8	36	21	6	6	13	436
	Sales representatives and agents	5	41	24	13	15	33	938
	Sales support workers	1	10	7	1	2	3	168
	Skilled animal and horticultural workers	3	10	5	2	1	5	183
	Specialist managers	15	135	139	92	60	165	2,403
	Sports and personal service workers	3	15	9	4	7	8	356
	Storepersons	1	13	11	1	1	6	168
	Occupation not listed	279	2,762	705	438	335	501	5,834
	All occupations	3,205	2,527	2,430	1,286	1,021	2,006	33,487

(a) Work related expenses include car-related expenses, travel expenses, clothing expenses, self-education expenses and other work related expenses.

(b) Low value pool deduction, deductible amount of undeducted purchase price of a foreign pension or annuity, deduction for project pool, forestry managed investment scheme deductions, election expenses and other deductions.

.. Not zero but rounded to zero.

**RESPONSE TO BUDGET ANALYSIS REQUEST
 – OUTSIDE THE CARETAKER PERIOD**

ATTACHMENT D – REQUEST 2 – PERSONAL INCOME TAX DEDUCTIONS (BY STATE)

Table D1 presents selected income tax deductions by state of residence of the individual taxpayer. The states have been determined from postcode data in individuals' tax returns.

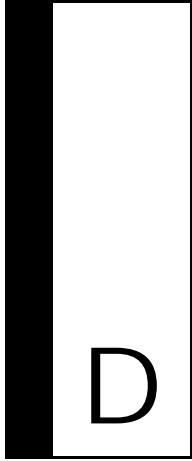
Table D1: Personal income tax deductions by state or territory, 2012-13

(\$m)	Work-related expenses ^(a)	Personal superannuation contributions	Cost of managing tax affairs	Gifts or donations	Dividends deductions	Interest deductions	Other deductions ^(b)	Total
New South Wales	6,843	942	886	990	411	397	605	11,074
Victoria	5,580	802	579	599	357	253	443	8,613
Queensland	4,333	569	459	341	234	168	445	6,549
Western Australia	2,080	455	317	236	160	129	283	3,660
South Australia	1,273	309	138	144	73	43	138	2,119
Tasmania	333	54	42	38	15	9	33	524
Australian Capital Territory	316	62	80	65	31	17	42	613
Northern Territory	212	11	24	15	3	5	16	286
State or territory not specified	41	1	2	2	1	..	2	48
Australia total	21,011	3,205	2,527	2,430	1,286	1,021	2,006	33,487

(a) Work related expenses include car-related expenses, travel expenses, clothing expenses, self-education expenses and other work related expenses.

(b) Low value pool deduction, deductible amount of undeducted purchase price of a foreign pension or annuity, deduction for project pool, forestry managed investment scheme deductions, election expenses and other deductions.

.. Not zero but rounded to zero.



Appendix D – Business Tax Deductions

Accident insurance premiums
Accountants fees for preparing returns
Accrued leave entitlements
Advertising expenses
Appeal costs relating to tax disputes
Audit costs, including ATO audit
Bad debts
Bank Charges, business
Bills of exchange, discount factor
"Black hole" expenses
Borrowing Expenses
Briefcases
Brokers Commission on Borrowed money
Buildings and Structural Improvements
Business operating expenses
Business subscriptions
Business trips, expenses of
Car expenses, business
Carbon prising
Commissions
Computer Software
Consolidation valuation expenses
Convention expenses
Copyrights, patents and registration of designs etc.
Corporate clothing

Credit expenses for work related expenses
Debt/Equity swaps resulting in a loss
Depreciation of business assets
Discounts or rebates on sale items
Dues; union, professional association or business associations
Education expenses
Election expenses: local government
Electricity connection costs
Employer cost of share schemes
Employment agreement; expenses of
Entertainment expenses business related (limited)
Environmental Impact study expense
Environmental protection expense
Equipment (work related)
Exchange losses
FBT payments
Feasibility study expenses for a new project
Film (Australia) investment
Financial arrangements losses
Fitness expenses
Forestry expenses
Geosequestration expenditure
GIC
Gift of art works or heritage items
Gift valuation fees under cultural program
Gifts of \$2 or more to prescribed recipients
Gifts: advertising or public relations
Glasses (anti glare)
Gratuities to employees
Higher qualifications expenses
Home office expenses where home used as a business premises
Insurance company, unreported claims
Insurance premiums - business related
Intellectual property
Interest underpaid tax where tax assessment is amended
Interest on borrowing to pay income tax
Interest on late lodgements
Interest on late payment of tax

Interest on money used for assessable income production or purchase of income-producing assets

Interest on money used to pay HELP

Interest referable to home office where home used as a business premises

Interest withholding tax

Investment losses

Investment portfolio, expenses of servicing

Land tax on business premises

Late payment interest penalty

Lease incentive payments

Lease preparation expenses

Lease termination payments (business)

Leave payments made by employer

Legal expenses - proceedings affecting future income

Legal expenses - relating to borrowing or mortgage discharge

Lessors or lessees payment to secure early termination of business leases

Living away from home allowances expenses

Loss on sale of property acquired before 20.9.85

Losses of company of current year

Losses of previous years

Losses of trust of current year

Losses on isolated business transactions

losses through theft or misappropriation

losses transferred from group company

Low cost items

Luxury car expenses

Mains electricity connection

Management expenses, investor

Mining expenditure

Mortgage discharge expenses

Motor vehicles dealers: warranty repair costs

Municipal rates on business premises

Natural disaster recovery expenses

Newspapers and magazines

Overtime meal allowances expenses

Parking fees

Partnership: share of net losses

Patent, design, copyright registration costs
Petroleum resource rent tax
Plant (installed) cost of bring to full operation
Political parties, contributions and gifts by non-business individuals
Primary production costs (most if not all costs tax deductible)
Professional journals: subscription
Professional qualifications
Project infrastructure costs
Promissory notes, discount factors
Protective clothing
Regional headquarters: set up costs
Relocation expenses incurred by employer
Rent collection: commissions on
Rent for business premises
Rent referable to home office (business)
Repair costs under warranty
Repairs to income producing property
Repayments of travel agents commissions
Retiring allowances
Salaries paid in business
Self education
Self education expenses
Self-insurance provisions or workers compensation
Service fees
Shortfall interest charges
Sickness/accident premiums
Software expenses
Solicitor disbursements
Spare parts
Special clothing, purchase and laundering
Sponsorship fees
Structural improvement (post 26.2.92)
Tax advice costs
Tax agents fees
Tax return lodgement costs
Technical and trade journals
Technical qualifications
Telephone expenses (work related)

Tender costs
Tools of trade
Tools, depreciation and cost of transporting and insuring
Trade union dues
Trading stock
Trading stock taken to new premises
Travel (relocation costs) paid by employer
Travel expenses related to business
Traveller accommodation buildings
Trees, carbon sink forest
Trees, purchased in immature forest or plantation and sold standing
Uniforms, special clothing for employees
Water facilities
Water rates on business premises
Work in progress payment

Source Wolters Kluwer, *Australian Master Tax Guide 2015, 56th edition, p.855 and following.*

Australian Greens Dissenting Report

Rationalising inequality: the logic of allowing millionaires to pay no tax

A country's tax system reflects a country's values and sense of equality. Ken Henry explained that:

The fairness of personal income tax is fundamental as an expression of societal values and is a prerequisite for people to be committed to the system and prepared to meet their obligations. There are two core elements to a fair system – a progressive tax rate structure and an appropriate definition of income.¹

By this measure, Australia is failing. Effective income tax rates are becoming less progressive. And the definition of income – effectively, the subject of this inquiry – is more elastic the more money you earn.

This comes at a time when inequality is on the rise. There are multiple factors contributing to rising inequality, in particular stagnant wages growth and overpriced housing. But the ability of the tax system to act as a check on inequality has diminished. There is no starker evidence of this than the ability of the rich to claim personal income tax deductions far in excess of the cost of doing their job or the cost of any of their expenses that might benefit broader society.

In the 2014-15 tax year 48 people who earned more the \$1 million paid no tax. They were able to claim deductions that reduced their income from \$1 million down to below the tax free threshold of \$18,200.

This is patently absurd. It also appears to be perfectly legal. Yet the Committee's report sees no problem.

Instead, the report hides behind the proposition that individuals should be able to deduct any legitimate expenses. This logic is devoid from reality.

In a tax system based on self-reporting, with a labyrinthine set of available deductions, and where there is no limit on these deductions, rich people spend lots of money paying accountants to reduce the amount of tax they pay.

Table 1 shows that the more money people earn, the more they spend on accountants to reduce their taxable income, an expense which is itself tax deductible. This trend is particularly marked for very high income earners. Individuals earning more than \$1 million spend more than \$8,000 managing their tax affairs to achieve deductions averaging over \$120,000. This is nearly a 15-fold 'return on investment'.

Figure 1 shows the distribution of deductions across income percentiles, and again shows the ability of the very wealthy to reduce the amount of tax they pay. The

¹ Australia's Future Tax System: Report to Treasurer – Part Two: Detailed Analysis, Vol. 1, December 2009

top 1% of income earners, people earning more than \$326,000 a year, deduct 6 times more than what those earning an average wage of around \$80,000.

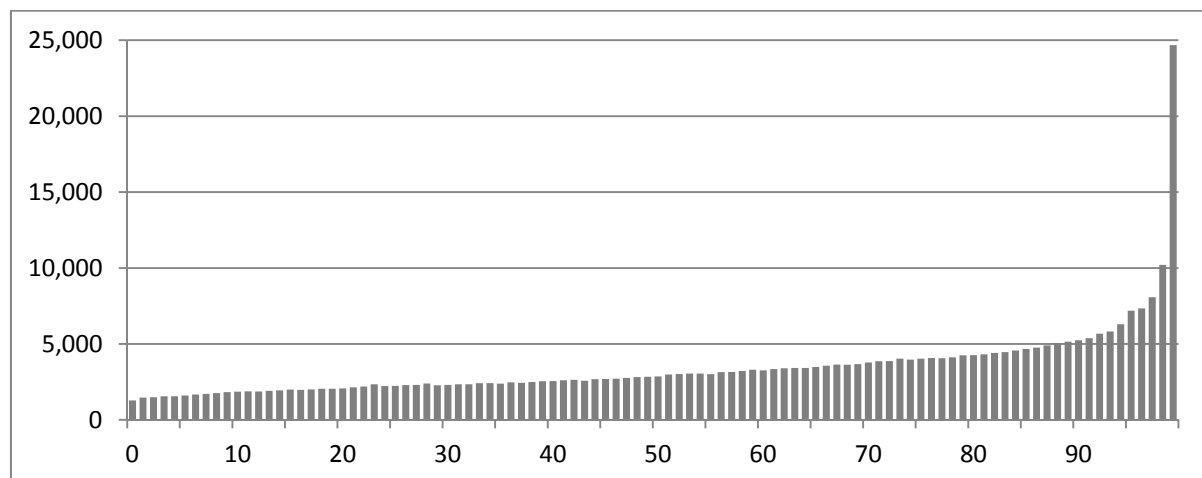
This is not fair. This is a rort.

Table 1: Cost of managing tax affairs by income band, 2014-15²

Income band	Cost of managing tax affairs
Less than \$0	\$186
\$0	\$64
\$1 to \$6,000	\$142
\$6,001 to \$10,000	\$55
\$10,001 to \$18,200	\$60
\$18,201 to \$25,000	\$80
\$25,001 to \$30,000	\$101
\$30,001 to \$37,000	\$113
\$37,001 to \$40,000	\$121
\$40,001 to \$45,000	\$128
\$45,001 to \$50,000	\$133
\$50,001 to \$55,000	\$141
\$55,001 to \$60,000	\$150
\$60,001 to \$70,000	\$161
\$70,001 to \$80,000	\$175
\$80,001 to \$90,000	\$195
\$90,001 to \$100,000	\$216
\$100,001 to \$150,000	\$277
\$150,001 to \$180,000	\$393
\$180,001 to \$250,000	\$539
\$250,001 to \$500,000	\$1,101
\$500,001 to \$1,000,000	\$2,285
\$1,000,001 or more	\$8,116

² ATO Tax Statistics 2014-15: Individuals - Table 10A

Figure 1: Total deduction by income percentile, 2014-15³



High income tax guarantee: time for a Buffet rule

The Buffet Rule is named after Warren Buffet, one of the world’s wealthiest investors who called for an income tax guarantee after discovering that he paid less tax than his secretary.

The Australian Greens believe it is time for a Buffet rule in Australia. Before the last election, the Parliamentary Budget Office (PBO) costed a policy that would put a limit on deductions that the top 1% of income earners can claim. By effectively requiring a minimum 35% on gross income, the PBO estimated that a high income tax guarantee would raise \$7.3 billion over the forward estimates.

A Buffet rule would help address inequality, would help the budget bottom line, and would be step towards restoring Australia’s reputation as place where everyone gets a fair go.

Recommendation: The amount of deductions available to the top 1% of income earners, by gross personal income, be limited such that they pay the top marginal tax rate for every dollar earned above this threshold.

³ ATO Tax Statistics 2014-15: Individuals – Table 16: Percentile distribution of taxable individuals, by percentile distribution on taxable income and gender