

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.

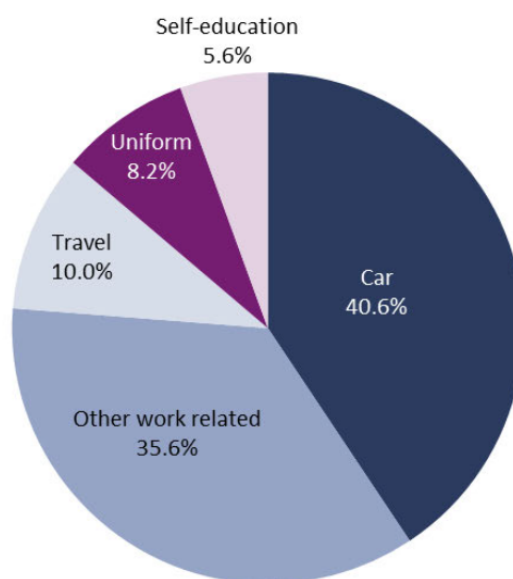
Deductions for work-related expenses

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
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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

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.