



15 January 2016

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Dear Sir

### **Simplification of the personal and company income tax system**

Chartered Accountants Australia and New Zealand (**Chartered Accountants ANZ**) welcomes the opportunity to contribute to the Standing Committee on Economics' (**the Committee**) deliberations on simplification of the personal and company income tax system, known as the Inquiry into tax deductibility (**the Inquiry**).

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## Terms of reference

The Committee has been asked by the Treasurer 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. 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.

## General comments

We note that this Inquiry is being held contemporaneously with the Government's Tax Reform process<sup>1</sup>, and no doubt the Committee's recommendations on the particular topics referred to it will be noted by the Treasurer and his advisers working on the White Paper.

Some of the points made in this submission also therefore appear in our submission<sup>2</sup> to the Re:think Tax Reform Discussion Paper<sup>3</sup>.

The issues referred to the Committee are contentious, and we are conscious that tax reform will be a key issue in the looming 2016 Federal Election. Nonetheless, we hope that the members of the Committee may find some common ground when formulating their recommendations.

### A. Work related deductions

#### *Deductibility of work-related expenditure – A fundamental feature of Australian tax law which can influence taxpayer behaviour*

From a practical perspective, the deductibility of work-related deductions reflects a relatively straightforward application of the general deduction principle in section 8-1 Income Tax Assessment Act 1997 (**ITAA 1997**).

Whilst we acknowledge that the Committee's Terms of Reference refer to individuals with *non-business* income, we think it wise to point out from the outset 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 distortionary, with some taxpayers likely to adapt by simply changing their tax strategy.

For example, 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<sup>4</sup> and the general anti-avoidance rule in the income tax law were not attracted – claiming the deductions as a taxpayer carrying on business.

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<sup>1</sup> Refer: <http://bettertax.gov.au/>

<sup>2</sup> Available from: <http://www.charteredaccountants.com.au/Industry-Topics/Tax/Exposure-drafts-and-submissions/Submissions/Treasury/120615-Tax-reform-and-the-politics-of-the-achievable.aspx>

<sup>3</sup> The Discussion Paper is available from: <http://bettertax.gov.au/publications/discussion-paper/>

<sup>4</sup> Refer Divisions 84, 85 and 86 ITAA 1997

Such behavior is already clearly evident in many businesses, notably building and construction, and in the transport and rural sectors.

Table 1 provides a simple example of the horizontal equity argument which could arise if *employee* work related deduction entitlements were diminished.

**Table 1: Income tax outcome for an employee v's individual contractor<sup>5</sup>**

	<b>Employee \$</b>	<b>Contractor \$</b>
Assessable income	80,000	80,000
Deductions (all 100% work related):		
• Home office (\$500)	0	(500)
• Self-education (\$1,000)	0	(1,000)
• Travel (\$500)	0	(500)
Taxable income	80,000	78,000
• Less: Income tax	(17,547)	(16,897)
• Less: Medicare Levy (2%)	(1,600)	(1,560)
After tax earnings	60,853	59,543



The Committee may wish to obtain up to date research about hiring trends in the workforce which could help guide its recommendations on work-related deductions.

There are many employee v's contractor issues which currently bedevil the Australian tax system at both Federal and State level. 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.

#### *Deductions for work-related expenditure: an entitlement in the eyes of some Australians?*

Changing tax policy is hard enough, but changing entrenched community attitudes is an altogether more challenging exercise. This is certainly true of changes impacting work-related expenditure.

There was a failed attempt by the former Labor Government to curtail work-related deductions from 1 July 2013. Labor's \$2,000 cap on self-education expenses (announced as part of the 2013-14 Budget, and delayed for one year in the 2013 Economic Statement) was later abandoned by the incoming Coalition government<sup>6</sup>.

In our view, 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). Although they are naturally aware of the withholding of PAYG tax at source, the withholding mechanism tends to reduce their full appreciation of the liability and they are more aware of their net "take home" pay. The annual opportunity after 30

<sup>5</sup> Calculation uses the individual resident tax rates for 2015-16. Available from:

<https://www.ato.gov.au/rates/individual-income-tax-rates/>

<sup>6</sup> Refer Joint Media Release by the Treasurer, Joe Hockey and the Assistant Treasurer, Senator Arthur Sinodinos, 6 November 2013, available from: <http://jbh.ministers.treasury.gov.au/media-release/017-2013/> This media release highlights the importance of data to the Committee's deliberations, with the Coalition partly justifying its decision on the basis that: "The highest number of self-education claims over \$2000 (i.e. 80%) come from people earning less than \$80,000 per annum."

June to lodge, claim deductions and obtain a refund is often seen in that light too – “getting back something that is mine”.

Most taxpayers 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. Improvements in technology, and initiatives such as the Single Touch Payroll<sup>7</sup>, mean that as a society we have the ability to achieve such calibration.

Some individuals also approach the claiming of deductions as a “square-up” opportunity, noting that their particular employer does not pay or reimburse the expenditure for which a deduction is sought. Common examples include unreimbursed self-education costs, work-related tools, occupation-specific clothing and footwear, and travel. This argument highlights a vertical equity issue associated with the diverse range of work situations now encountered in the community, with contracted, temporary, casual or part-time workers increasingly required to supply their own uniform, equipment etc.



Societal attitudes towards work-related deductions are well-entrenched. Any 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.

### *Are work-related deductions being over-claimed? – The tax gap issue*

There are situations encountered by Chartered Accountants which indicate that some taxpayers simply do not meet the three basic eligibility criteria for a deduction.

These are situations where the work-related expense:

- 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<sup>8</sup>. 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.

In a self-assessment system in which individuals are increasingly being enticed to lodge their tax returns online using myTax, the Committee needs data about the risk that work-related deductions are simply being claimed by individuals without any basis under the income tax law.

Note too 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,

<sup>7</sup> For information about the Single Touch Payroll project, refer: <https://www.ato.gov.au/General/New-legislation/In-detail/Other-topics/Single-Touch-Payroll/>

<sup>8</sup> The recent ATO investigation of workplace deductions claimed by some individuals engaged at the Bechtel project at Curtis Island in Queensland graphically highlights this particular problem. Refer:

<https://www.ato.gov.au/Individuals/Ind/In-detail/Bechtel-employees-at-Curtis-Island/>  
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cynics will argue that 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).



The Committee will no doubt receive from the ATO its latest data on the extent to which work-related deductions are claimed, by whom, and a comparison between deductions claimed in self-prepared and tax agent prepared returns.

We also understand that the ATO has undertaken some “tax gap” analysis on the extent to which work-related expenses are over-claimed. This analysis would help the Committee determine the extent to which such deductions impact the tax base.

The Committee may also wish to hear from community and employee representatives about likely worker reactions to the denial of work-related deductions, and the compensating policies that might be needed to placate any concerns.

### *The role of the tax system in recognising personal circumstances*

Australians work in many diverse industries and workplaces. The ATO currently acknowledges this diversity in a range of occupation-based public taxation rulings and (as we understand it) in setting “tolerances” for deductions claimed as part of its risk differentiation framework<sup>9</sup>.

This diversity is captured in the following extract from an article by Jonathan Baldry urging reform<sup>10</sup> (references are to ATO public rulings published at the time the article was written<sup>11</sup>):

“For example, a shearer may claim deductions for jeans used as working clothes (TD 94/48), even though many people buy and wear jeans, and many shearers would buy them as nonworking clothes. By contrast, the clothes worn by plain-clothes police officers are not allowable deductions (TR 95/13). Flight attendants, required to be well groomed on the job, cannot claim personal grooming expenses (TR 95/19) (as distinct from moisturisers, hair conditioners and the like, which are allowable deductions in recognition of the harsh working environment), while physical training instructors are able to claim the off-the-job costs of keeping fit, which is a necessary requirement for their occupation (TD 93/110).”

Baldry argues that this approach produces “arbitrary and inequitable” outcomes: 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. An increasing number of Australians also have two or more jobs to help make ends meet, and the income tax law currently recognizes an entitlement to a deduction for the cost of travelling between two workplaces.

<sup>9</sup> For more on the ATO risk differentiation framework, see: <https://www.ato.gov.au/general/building-confidence/public-and-international-groups/transparency/how-we-assess-and-manage-risk/>

<sup>10</sup> Jonathan Baldry, *Abolishing Income Tax Deductions for Work-Related Expenses*, Agenda, Vol5, No 1, 1998, pages 49-60. Available from: <http://press.anu.edu.au/wp-content/uploads/2011/07/5-1-A-5.pdf>

<sup>11</sup> Available from: <https://www.ato.gov.au/Tax-professionals/Compliance-for-tax-professionals/Work-related-expenses/Taxation-rulings-for-specific-occupations/>  
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But as Baldry also acknowledges, employers seeking to hire labour in areas where there is a skills shortage 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”.



The Committee would benefit from evidence from employer organisations about the potential broader workplace effects of changes to the deductibility of work-related expenses.

Such insights may (for example) lead to the Committee considering broader issues such as the need to review workplace safety laws and workplace agreements to determine where employers (payers) should be obliged to provide relevant equipment to workers.

### *The broader impact of denying deductions for work-related expenditure*

Although not within the Committee’s terms of reference, we feel that some consideration should be given to the broader aspects of changing the rules surrounding deductibility of work-related expenses.

For example, Committee members may wish to 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.
- The extent to which tax deductibility influences consumption choices and spending behaviour, particularly around the end of the financial year (e.g. pre-30 June deals on personal electronic devices, computers, software, and tools of trade, promoted partly on the basis of the tax deductions that may be available and the “cash back” aspect of the resultant tax refund).
- The extent to which deductibility encourages expenditure which produces desirable economic and/or social outcomes. An example of the former might be membership subscriptions for associations or trade unions which advance the cause of their members. An example of the latter would be the deductions allowed for expenditure on protective items used at work where these items are not employer (or payer) provided<sup>12</sup>.



We acknowledge those who would counter the above comments by saying that tax deductibility is an implicit subsidy encouraging certain activities or outlays and is, itself, distortionary.

Nonetheless, Committee members need to be cognisant of the broader ramifications of policy change and the likely sources of resistance to change.

<sup>12</sup> Refer ATO Public Ruling TR 2003/16, available from:

<https://www.ato.gov.au/law/view/view.htm?src=hs&pit=99991231235958&arc=false&start=1&pageSize=10&total=5&num=3&docid=TXR%2FTR200316%2FNAT%2FATO%2F00001&dc=false&tm=and-basic-94%2F48>  
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### *Denying deductions, minimum spend floors, deduction caps and new eligibility rules – the various approaches of dealing with work related expense claims*

The simplest “clean slate” approach to reforming the tax deductibility of work related expenses is to simply deny the deductions outright (subject to compensatory mechanisms referred to later in this submission).

There are however alternatives which the Committee may wish to consider. These include limiting deductions by establishing:

- 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<sup>13</sup>.

### **Work related deductions – The case for change**

Notwithstanding the abovementioned difficulties of policy changes in this area, there are several key arguments for the Committee to consider which support reforming the current tax policy towards worked-related deductions.

#### *The impact on revenue collections*

The level of work-related deductions claimed by employees and self-employed individuals has grown over the years (see Table 2 below), and may now have reached a level where – in a tax reform context – new approaches are needed.

**Table 2: Total work related deductions<sup>14</sup>**

<b>Tax Year</b>	<b>\$million</b>
1999 - 2000	7,763
2000 - 2001	8,753
2001 - 2002	9,630
2002 - 2003	10,207
2003 - 2004	11,101
2004 - 2005	11,930
2005 - 2006	13,067
2006 - 2007	14,166
2007 - 2008	16,098
2008 - 2009	16,362
2009 - 2010	17,939
2010 - 2011	18,270
2011 - 2012	19,358
2012 - 2013	19,761

<sup>13</sup> For more information on employee deduction entitlements in Sweden, see:  
<http://www.skatteverket.se/servicelankar/otherlanguages/inenglish/individualsandemployees/declaringtaxesforindividuals/commondeductionsinthetaxreturn.4.7be5268414bea064694c75e.html>

<sup>14</sup> Source: Australian Taxation Office Taxation Statistics – various years.  
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## Equity

There is an argument that work-related deductions undermine the equity of Australia's tax system in that particular occupational groups are favoured by the current regime, with the result that their post-tax outcomes are better than other individual taxpayers on equivalent gross incomes<sup>15</sup>.

Australia's progressive income tax scales also enhance the value of tax deductions in proportional terms as taxpayers move into higher tax brackets, just as they impose higher tax rates as taxable income climbs.

Those who can claim work-related deductions may also obtain private benefits from their deductible expenditure even though, strictly speaking, the deduction claimed should be apportioned for private use. An example here is tax depreciation on a laptop which an employee argues is used solely for work or work-related self-education.

Any horizontal equity analysis in this context is complicated however by the impact of the Fringe Benefits Tax regime, where some benefits are exempt or concessional taxed, with the incidence of tax on taxable benefits falling on the employer. Some employers absorb the cost of FBT, others pass it on to employees. Also, not all employers provide salary sacrifice arrangements to employees. Comparing the overall tax outcome can be complicated in such cases, particularly in situations involving the popular practice of salary sacrificing superannuation contributions.

And as noted earlier however, there are also arguments to the contrary which would support work-related expense deductions on equity grounds.



We recommend that the Committee obtain data from Treasury and ATO officials which help determine the extent to which work-related deduction entitlements result in inequitable outcomes for taxpayers on comparable incomes.

## Compliance costs - Simplicity

The Re:think Tax Reform Discussion Paper highlights what are perhaps the key arguments for change – the compliance cost burden associated with Australia's current treatment of work-related expenses and the need to simplify the law. The Paper refers to one possible alternative mechanism, a standard deduction<sup>16</sup>.

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.

<sup>15</sup> An indication of the differing work-related deduction entitlements can be gleaned from the ATO's public taxation rulings for specific occupations (see above).

<sup>16</sup> Refer page 54-55 of the Discussion Paper, available from: <http://bettertax.gov.au/publications/discussion-paper/>. Put simply, a standard deduction would remove the cost of identifying and itemizing deductions, and the associated substantiation and record retention burden. As noted by the authors of the Discussion paper, a standard deduction approach allows those who would otherwise have a low dollar value deduction entitlement to "step-up" to the higher standard entitlement.





Only those United Kingdom individuals with exceptional circumstances need lodge an annual tax return<sup>21</sup>.

In practice, this outcome is achieved because of the combined impact of several types of allowances and an efficient, accurate mechanism for withholding tax at source mechanism.

The main features of the UK system which help achieve this outcome include:

- A standard Personal Allowance of £10,600, which is the amount of income most individuals don't have to pay tax on<sup>22</sup>
- Savings interest derived in taxable circumstances (the UK has tax free savings accounts known as Individual Savings Accounts or "ISAs") is automatically taxed at 20%, and only higher rate taxpayers pay additional tax on interest<sup>23</sup> and tax on dividends<sup>24</sup>
- An annual CGT allowance (annual exempt amount) of £11,100<sup>25</sup>
- HMRC calculate a tax code used by a taxpayer's employer to determine how much income tax to deduct from salary or wages.

Note too that self-employed persons in the United Kingdom must lodge, but can claim certain types of deductions using simplified procedures<sup>26</sup>.

- *The New Zealand model*

In the case of New Zealand, the decision to abolish work-related expense deductibility in the late 1980's was part of a radical broad-base, low rate tax reform initiative driven by the Labour Government under the stewardship of David Lange and Roger Douglas.

It should also be acknowledged that the passage of this and other tax reform policies in New Zealand was assisted by that country's unicameral Parliament.

Further details on the New Zealand reforms is provided at [Attachment A](#).

### *The politics of the achievable*

We acknowledge the enormously difficult political task of convincing the electorate to embrace tax reforms impacting their personal tax and financial affairs.



To pre-empt and seek to head-off resistance to changes to the treatment of work-related expenses, we envisage 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).

<sup>21</sup> Refer HMRC website for the list of circumstances requiring lodgment of an annual income tax return. Available from: <https://www.gov.uk/self-assessment-tax-returns/who-must-send-a-tax-return>

<sup>22</sup> Refer HMRC website. Available from: <https://www.gov.uk/income-tax-rates>

<sup>23</sup> Refer HMRC website. Available from: <https://www.gov.uk/apply-tax-free-interest-on-savings>

<sup>24</sup> Refer HMRC website. Available from: <https://www.gov.uk/tax-on-dividends>

<sup>25</sup> Refer HMRC website. Available from: <https://www.gov.uk/capital-gains-tax/allowances>

<sup>26</sup> Refer HMRC website. Available from: <https://www.gov.uk/simpler-income-tax-simplified-expenses>

- 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<sup>27</sup>.
- 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.

## B. Interest deductibility

### *Deductibility of interest expense – A fundamental feature of Australian tax law*

Interest deductibility is also largely authorized by the general deduction provision in the income tax law, section 8-1 of the ITAA 1997.

For business taxpayers in particular, the deduction is vitally important in managing the cost of capital.

Nonetheless, interest deductions have proved to be particularly problematic for tax policy makers over the years.

For business taxpayers involved in cross-border arrangements, Australia has embraced a complex web of interest deduction safeguards which include:

- Domestic thin capitalization rules applicable to both inbound and outbound structures, with the rules now applying where, in broad terms and applying what is known as the “safe-harbour” approach, debt exceeds 60% of the net value of the Australian investments (prior to 1 July 2014, it was 75%).
- Rules which categorise a financial instrument as either debt (interest typically deductible) or equity (no interest deduction).
- Transfer pricing anti-avoidance rules, with an associated penalty regime which has recently been amended to double the applicable penalties.
- A general anti-avoidance rule, which has been recently strengthened by the addition of a multinational anti-avoidance provision.

The Government is also currently considering OECD recommended multi-lateral changes to international tax laws to address base erosion and profit shifting caused (amongst other things) by interest deductions (discussed further below).

For a wholly domestic business structure however (and assuming the financing instrument is categorised as debt and no anti-avoidance rules apply), full interest deductibility generally applies. Committee members would be aware that there was a short-lived attempt in the mid-1980's to restrict interest deductions for negatively geared residential property, with one of the practical problems encountered at the time being the differentiation between property investor (non-business) and property developer (business) tax profiles.

Care needs to be taken when considering the alteration of rules regarding the deductibility of interest, as they are inextricably linked to other provisions of the tax act. For example:

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<sup>27</sup> In this regard, the Single Touch Payroll project holds great promise. Refer Minister for Small Business and Assistant Treasurer (Ms Kelly O'Dwyer) press release, 21 December 2015. Available from: <http://kmo.ministers.treasury.gov.au/media-release/042-2015/>  
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- *The treatment of capital gains*  
The recent Murray Inquiry noted the asymmetric tax treatment of interest costs and other expenses (deductible) and capital gains (taxed concessional) and the encouragement this gives to leveraged investment<sup>28</sup>. Although these comments were made primarily in the context of negatively geared investment property, they are also relevant in a business context where a number of CGT concessions are also available.
- *The dividend imputation system*  
Interest deductions are generally available for financing the acquisition of the income producing asset (i.e. shares in a resident company) yielding franked dividends which carry a tax offset entitlement.
- *Debt equity rules*  
These rules help categorise financial instruments as debt or equity for a range of income tax purposes.
- *Pay As You Go (PAYG) withholding on interest paid to non-residents*  
Note here that Australia has granted various PAYG withholding concessions in a bid to promote access to global capital markets, given the comparatively small size of our domestic banking sector.



These general introductory comments are simply intended to demonstrate to Committee members just some of the many implications of changing the current status quo on interest deductibility, in terms of broader tax policy considerations.

### *OECD Base Erosion and Profit Shifting (BEPS) recommendations*

The final BEPS recommendations were released on 5 October 2015 and include recommendations on Action Item 4 of the BEPS Action Plan<sup>29</sup>. This action item deals with limiting interest deductions, where the OECD has concerns about three planning arrangements in which entities:

- Place higher levels of third party debt in high tax countries
- Use intragroup loans to generate interest deductions in excess of third party interest expense
- Use debt to fund the generation of tax exempt income

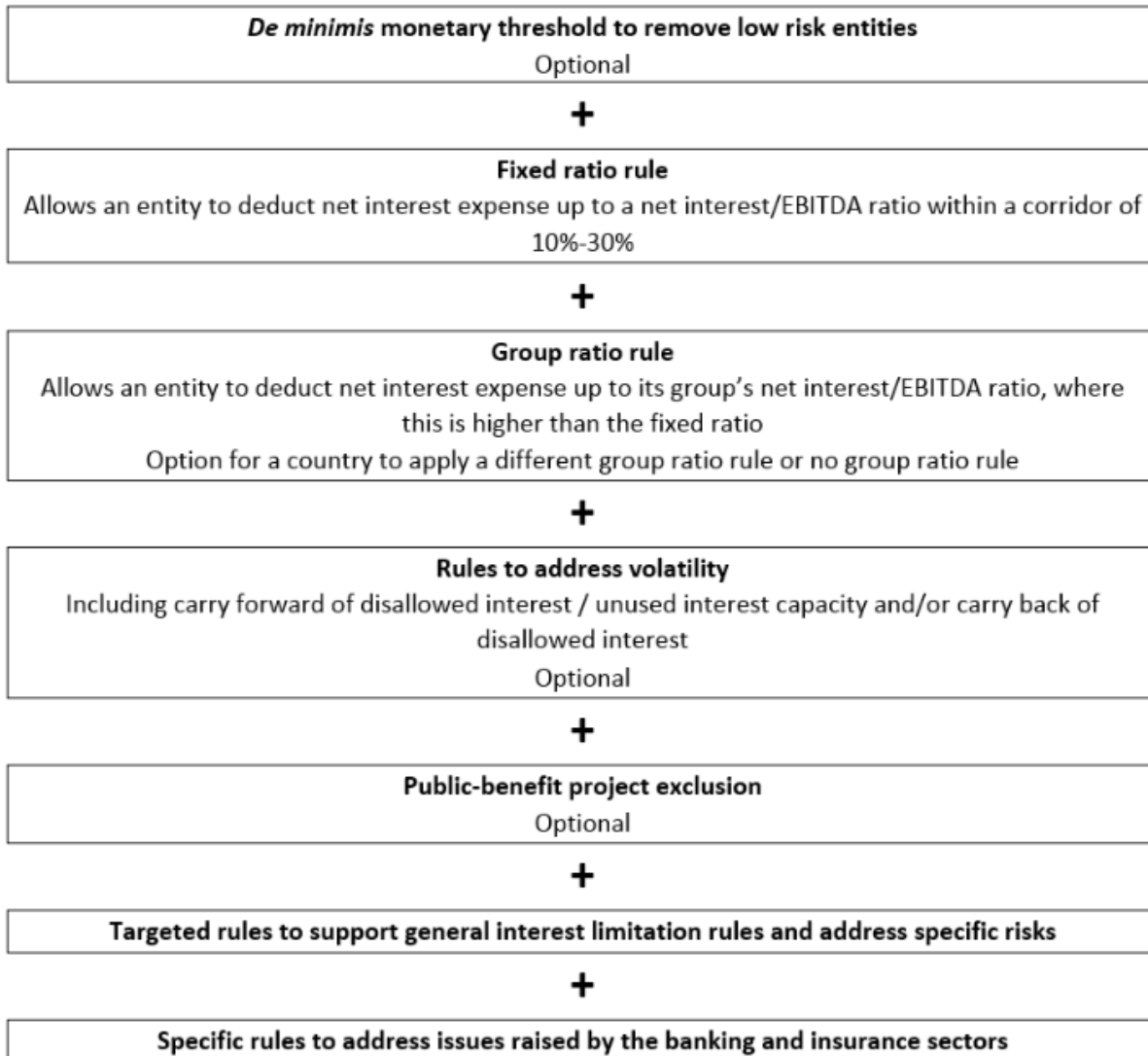
The OECD's recommendations on Action 4 are summarized in Diagram 1<sup>30</sup>.

<sup>28</sup> Source: <http://fsi.gov.au/> Refer Appendix 2, Tax Summary.

<sup>29</sup> *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report*, OECD, 5 October 2015. Available from: <http://www.oecd.org/tax/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-report-9789264241176-en.htm>

<sup>30</sup> Action 4 - 2015 Final Report, OECD. (Op cit). Page 25.

**Diagram 1: Summary of the OECD best practice recommendations on Action 4**



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 amortization (EBITDA) based on tax numbers. The percentage restriction should be set by each jurisdiction at a single benchmark fixed ratio of between 10% and 30% of EBITDA.

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.



It is important for the Committee to note the OECD's comment that, if the proposed fixed ratio range was embraced, 87% of listed companies it studied would in principle be able to deduct all of their net third party interest expense.

The Committee should also be conscious of the tax competition which could occur here between nations. A country could deliberately adopt a higher fixed ratio designed to attract international investment based on more lenient interest deductibility rules.

Such tactics highlight (yet again) the need for a multi-lateral approach to implementing the OECD recommendations.

Another important issue for the Committee to appreciate is that any decision to link net interest deductions to the level of an entity's EBITDA will need to address volatility in earnings. This is a key concern of trade-exposed industries in Australia. One possibility proposed by the OECD is the use of average figures over, say, a three-year period. Committee members may wish to discuss the pros and cons of such averaging with leading Australian companies involved in the Committee's consultation process.

The recommendations explore the possibility of limiting interest deductions using an asset values test as a measure of economic activity (Australia's current "safe harbour" thin capitalisation approach). Although a fixed ratio based on asset values is not part of the OECD's recommended best practice approach, the OECD says that "this is not intended to suggest that these tests cannot play a role within an overall tax policy to limit interest deductions"<sup>31</sup>.



The OECD says an asset approach provides greater certainty for groups as a ratio based on asset values would be more stable than a ratio based on earnings, but acknowledges the compliance costs associated with the valuation of assets. In our view, companies should have the option of using whichever is more suitable.

The OECD also recommends a worldwide gearing, group ratio rule to operate alongside the fixed ratio rule as an optional fall back. This rule allows an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of net third party interest/EBITDA ratio of its worldwide group, using the formula:

$$\text{Group ratio} = \frac{\text{Group interest}}{\text{Group EBITDA}}$$

Where:

- *Group interest* is total net third party interest for the group.
- *Group* is defined in line with accounting standards, and would exclude portfolio holdings, associates, joint ventures and subsidiaries recognised at fair value.

The formula would be potentially subject to an overall cap of 100% of total group interest, although countries would be able to apply an uplift of up to 10% to prevent double taxation.



The Committee should explore with businesses the impact of implementing a fixed ratio rule, together with a fall-back group ratio rule. The applicable percentages will be important in this context: for example, a high fixed ratio may not be as effective in addressing BEPS risks as, say, a lower fixed ratio combined with the fall-back group ratio rule.

Committee members should note that the OECD is to undertake further work to determine the extent to which (if at all) the ratio calculation should be adjusted for tax items (i.e. a tax adjusted measure of EBITDA rather than an accounting concept) and loss-making entities, and there is an acknowledged need for anti-

<sup>31</sup> Action 4 2015 Final Report, OECD (op cit). Para 17.  
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avoidance rules to prevent group ratios from being inflated artificially by interest paid outside the group to related parties.

From a taxpayer perspective, there is concern about the compliance costs associated with constantly monitoring and adjusting leverage across multiple jurisdictions, suggesting to us that buffers may be necessary to prevent the need for constant, relatively minor adjustments.

Chartered Accountants ANZ also notes that, prior to the release of the OECD's recommendations, the Australian Labor Party had already announced<sup>32</sup> that, if elected, it would implement a worldwide gearing ratio so that "tax deductions will be based on a company's entire global operations, not just what they do in Australia":

"Labor is proposing to amend the current thin capitalisation rules to reduce the amount of debt that multinational companies can claim deductions for in Australia. Companies will no longer be able to claim up to a 60 per cent debt-to-equity ratio for their Australian operations. Instead, deductions will be assessed on the debt-to-equity ratio of a company's entire global operations. This means that if a company has an average 30 per cent debt-to-equity ratio across its different subsidiaries, it will only be able to claim tax deductions up to that level."

It is unclear to us whether the ALP's policy will be revisited in the light of the OECD's recommendations.

As for the arm's length test, the OECD says a country may continue to apply an arm's length test alongside the recommended fixed ratio rule, despite the complexity associated with applying such a test (as demonstrated in the *Chevron case*<sup>33</sup>).

The report also suggests (or acknowledges):

- A de minimis rule to exclude entities with a low level of net interest expense (Australia's 'de minimis' threshold for thin capitalisation limits was increased from \$250,000 to \$2 million of debt deductions from 1 July 2014).
  - We note that this threshold needs to be monitored not just in terms on easing compliance, but also in response to upward movements in interest rates.
- An exclusion for interest paid to third party lenders on loans used to fund "public benefit" projects such as utilities and other infrastructure.
  - We note that public benefit would need to be defined in an Australian context, to determine whether and how (for example) major resource projects might fall within this categorization.
- Carry forward (or back) disallowed interest expense (this may be a key concern of entities operating in long-lead time projects such as mining, oil and gas, utilities and infrastructure, where the interest incurred to fund a project gives rise to earnings in a future period).

<sup>32</sup> Australian Labor Party, *Big multinational companies should pay their fair share of tax*. Available from: <http://www.theirfairshare.org.au/ourpolicy>

<sup>33</sup> *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4)* [2015] FCA 1092 (23 October 2015). Available from: <http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/FCA/2015/1092.html?stem=0&synonyms=0&query=chevron>  
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- We note that Australia does not have general loss-carry back rules and specific interest carry back arrangements will add complexity, particularly because of our imputation rules.
- The need for special rules for the banking and insurance sectors.
  - We note that these sectors are already subject to existing financial regulation and the issues here extend far beyond just the realm of tax.
- That large groups are in a different position than other entities when raising third-party debt and, therefore, to create a level playing field there may be reasons to justify a higher fixed ratio for medium-sized groups who are nonetheless above the de minimis threshold.
- Various options for “grandfathering” third party debt and related party debt. For example, a country could apply transitional rules which exclude interest on certain existing loans, either for a fixed period or indefinitely. The OECD recommends that these transitional rules are primarily restricted to interest on third party loans entered into before the rules were announced.
  - The OECD’s expectation is that grandfathering would apply only in exceptional circumstances. We expect that those businesses engaged in long-term projects impacted by any changes will strongly urge otherwise.



Overall, Australia’s current thin capitalisation regime already has many of the hallmarks of the OECD’s *flexible* approach to limiting interest deductions. The relevant tax law is administered by a vigilant ATO.

The flexibility in the OECD’s recommended approach is in our view warranted because different industries have different levels of leverage, and an open economy like Australia – with substantial resource and infrastructure development needs – will have different policy considerations in determining threshold ratios suited to our economy.

Also, Action 4 recommendations should not be seen in isolation from the OECD’s other Action Plan recommendations (e.g. on hybrid mismatches and treaty anti-abuse) which will also help address base erosion through the inappropriate deduction of interest.

We therefore support the Treasurer’s response to the OECD recommendations<sup>34</sup>, where he said the Government would 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. The intricate and sensitive nature of international taxation demands precise and targeted responses to policy challenges, responses that are developed in consultation with our international partners to maximise their effectiveness.”

Put simply, we now appear to be at a stage in the BEPS process where the reactions of governments around the world are being monitored to see whether and how they intend to proceed. Consultation processes are underway in jurisdictions such as the United Kingdom<sup>35</sup>.

<sup>34</sup> Treasurer’s press release, 6 October 2015. Available from: <http://sjm.ministers.treasury.gov.au/media-release/003-2015/>

<sup>35</sup> Refer: <https://www.gov.uk/government/consultations/tax-deductibility-of-corporate-interest-expense>  
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In our view, it would be unwise for Australia to be a “first mover” in implementing the OECD recommendations.

Nonetheless, the Committee’s current Inquiry provides a useful forum for further consultations to occur.

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### **Publication of our submission**

Chartered Accountants ANZ consents to publication of this submission on the Committee’s website.

### **Further information and appearance before the Committee**

I am happy to discuss any aspect of our submission with you should further information be required.

However I will be on annual leave and travelling overseas from 1 February to 26 February 2016 (inclusive). If the Committee decides to hold a public hearing during this period, I will arrange for another to represent our organisation.

I can be contacted on (02) 9290 5609 or at [michael.croker@charteredaccountantsanz.com](mailto:michael.croker@charteredaccountantsanz.com)

Yours faithfully,

**Michael Croker**  
**Tax Leader Australia**  
**Chartered Accountants Australia and New Zealand**

## Insights on the New Zealand experience

The Terms of Reference refer specifically to the treatment of work-related expenses in New Zealand where, since the late 1980's, such deductions have generally ceased to be available.

Prior to that time, a salary or wage earner was able to claim a deduction for the greater of:

- 2% of employment income for the income year or \$52 (whichever was the lesser), or
- the actual expenditure incurred in earning their employment income.

Only expenditure of the types listed in the income tax law was able to be claimed (e.g. protective clothing and uniforms, work-related qualifications and refresher courses, travel in the course of employment and home office expenses).

### *The broader tax reform context*

Whilst we acknowledge the simplicity of the New Zealand approach, that country's reforms to the tax deductibility of work-related expenses should not be considered in isolation. They were part of a major base broadening tax reform process undertaken by the New Zealand Labour Party under the leadership of Prime Minister David Lange and Minister of Finance, Roger Douglas, and reflected a range of recommendations drawn from the:

- 1967 Ross Report<sup>36</sup>
- 1981 report by the New Zealand Planning Council<sup>37</sup>
- 1982 McCaw Task Force on Tax Reform<sup>38</sup>

These reforms included the introduction of a broad-based GST levied at 10% from 1 October 1986 to replace almost all indirect taxes (the rate has subsequently increased twice, to 12.5% in 1989 and to the current 15% rate in 2010).

With hindsight, the broad-base low-rate tax policy is now widely regarded in New Zealand as a nation-building reform, with the resultant economic benefits now clear for all too see<sup>39</sup>.

Note in particular the impact that base broadening tax reform in New Zealand had on individual marginal tax rates and company tax rates during the tax reform years (see Tables 3 and 4) reflecting a policy decision to decrease reliance on income tax (especially individual income tax).

Apart from the indirect tax reforms, the achievement of lower personal tax rates was helped by the removal of a number of personal income tax concessions, not just the "standard deduction"

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<sup>36</sup> Taxation Review Committee. *Taxation in New Zealand: Report of the Taxation Review Committee*. Wellington: Government Printer, 1967.

<sup>37</sup> New Zealand Planning Council, *An Agenda for Tax Reform*. Wellington: New Zealand Planning Council, 1981. The NZPC adopted a "clean slate" approach to tax reform, with even the principle of progressive taxation open for discussion. It recommended that any review of personal taxation should examine the rates structure to assess the feasibility of reducing marginal tax rates or adopting a proportional income tax, as well as reassessing the place of deductions, exemptions and rebates.

<sup>38</sup> *Report of the Task Force on Tax Reform*. Wellington: Government Printer, 1982.

<sup>39</sup> OECD, *Economic Survey of New Zealand 2015*. Available from: <http://www.oecd.org/newzealand/economic-survey-new-zealand.htm>

for work-related expenses. These personal tax changes are well summarized in the McLeod Committee's 2001 Final Report<sup>40</sup>.

**Table 3: Individual Marginal Tax Rates in New Zealand (1985 to 1989, and now)<sup>41</sup>**

1985		1986		1987	
Income range NZD\$	%	Income range NZD\$	%	Income range NZD\$	%
0-6,000	20	0-6,000	20	0-6,000	17.5
6,001-24,000	32	6,001-25,000	33	6,001-9,500	24
24,001-25,000	41.06	25,001-30,000	41	9,501-25,000	31.5
25,001-30,000	45.1	30,001-38,000	51	25,001-30,000	37.55
30,001-38,000	56.1	Over 38,000	66	30,001-38,000	52.05
Over 38,000	66			Over 38,000	57
1988		1989		2016	
Income range NZD\$	%	Income range NZD\$	%	Income range NZD\$	%
0-9,500	15	0-9,500	19.5	0-14,000	10.5
9,501-30,000	30	9,501-30,000	27	14,001-48,000	17.5
Over 30,000	48	30,001-30,875	36	48,001-70,000	30
		Over 30,875	40.5	Over 70,000	33

**Table 4: Company tax rates in New Zealand (1985 to 1989, and now)<sup>42</sup>**

1985 %	1986 %	1987 %	1988 %	1989 %	2016 %
45	45	48	48	28	28

#### *Other important features of the New Zealand personal tax and transfer payment system*

It is always dangerous to look at single tax topics, such as the deductibility of work related expenses, without an understanding of the broader context of the tax rules impacting employees.

There are various other features of the New Zealand personal tax and transfer payment system which Committee members should bear in mind.

<sup>40</sup> *Final Report - Tax Review 2001*. Wellington: Government Printer, 2001. For details of the personal taxation reforms during the 1980's, refer Chapter 1 pages 9 to 11. Available from: <http://www.treasury.govt.nz/publications/reviews-consultation/taxreview2001/taxreview2001-report.pdf>

<sup>41</sup> Source: Roger S. Muir, *The Goods and Services Tax: Reflections on the New Zealand Experience, Six Years On*, Revenue Law Journal, Vol 3, Issue 2, Article 2, 1993. Available from: [http://epublications.bond.edu.au/rj/vol3/iss2/2/?utm\\_source=epublications.bond.edu.au%2Frlj%2Fvol3%2Fiss2%2F2&utm\\_medium=PDF&utm\\_campaign=PDFCoverPages](http://epublications.bond.edu.au/rj/vol3/iss2/2/?utm_source=epublications.bond.edu.au%2Frlj%2Fvol3%2Fiss2%2F2&utm_medium=PDF&utm_campaign=PDFCoverPages) Current tax rates from IRD website.

<sup>42</sup> Source: Roger S. Muir (op cit). Current tax rates from IRD website.  
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For example:

- Many salary and wage earners do not need to lodge an annual income tax return<sup>43</sup>, with a relatively simple system of tax codes used to determine the appropriate amount of PAYE to be withheld by the employer at source<sup>44</sup>
- A resident withholding tax applies to interest and dividend income<sup>45</sup>
- A flat rate tax on schedular payments (formerly known as withholding payments) applies to payments made to contractors and entities such as partnerships who perform specified types of activities<sup>46</sup>
- A 33.3 cents in the dollar tax credit applies to payroll donations, resulting in a reduction in the employee's Pay As You Earn gross amount<sup>47</sup>
- The New Zealand government provides "Working for families" tax credits to assist low- and middle-income families<sup>48</sup>
- Self-employed persons and sole traders (e.g. contractors) must lodge an annual income tax return<sup>49</sup>, and are entitled to a range of deductions for expenses incurred<sup>50</sup>. Upon lodging their first return as a self-employed person, they typically enter the provisional tax system<sup>51</sup>, the New Zealand equivalent of Australia's PAYG instalment system.
- Superannuation saving via KiwiSaver is a voluntary opportunity<sup>52</sup>
- Accident Compensation Corporation (ACC) is compulsory in New Zealand, with employees paying the ACC levy via the PAYE system<sup>53</sup>



Chartered Accountants Australia and New Zealand has two tax teams, based in Sydney and Auckland.

Peter Vial, our New Zealand Tax Leader, is available to provide Committee members with further insights on the New Zealand personal tax system, including the tax reforms which have occurred in this area over the years.

<sup>43</sup> In broad terms, an individual tax return is required only if the taxpayer earned income other than salary, wages, interest, dividends, and/or taxable Māori authority distributions. Taxpayers can complete a worksheet to determine whether a personal tax return is necessary. Note the limited range of deductible expenses available, none of which relate to work-related expenditure. Refer: <http://www.ird.govt.nz/resources/c/1/c17b2078-3017-4b9f-abc3-c51d09187697/ir746-2015.pdf>

<sup>44</sup> Refer: <http://www.ird.govt.nz/income-tax-individual/basics/>

<sup>45</sup> Refer: <http://www.ird.govt.nz/rwt/>

<sup>46</sup> Refer: <http://www.ird.govt.nz/payroll-employers/make-deductions/withholding-tax/emp-deductions-salaries-wt-deductions.html>

<sup>47</sup> Refer: <http://www.ird.govt.nz/payroll-employers/returns-payments/pay-give-emp/payroll-giving-employers.html>  
Employees can also claim deductions for after tax donations – refer: <http://www.ird.govt.nz/income-tax-individual/tax-credits/dch-taxcredits/>

<sup>48</sup> For details of the various Working for Families Tax Credits in New Zealand, refer: <http://www.workingforfamilies.govt.nz/tax-credits/> Persons receiving such tax credits are sent a "change of circumstances" form at the end of the tax year to update the information held by Inland Revenue.

<sup>49</sup> Refer: <http://www.ird.govt.nz/income-tax-individual/end-year/ir3/>

<sup>50</sup> Refer: <http://www.ird.govt.nz/business-income-tax/expenses/>

<sup>51</sup> Refer: <http://www.ird.govt.nz/business-income-tax/paying-tax/prov-tax/>

<sup>52</sup> Refer: <http://www.kiwisaver.govt.nz/>

<sup>53</sup> Refer: <http://www.acc.co.nz/for-individuals/employees/index.htm>