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Joint Committee of Public Accounts and Audit Inquiry

Inquiry reviewing a range of taxation issues within Australia

PART B – The Application of Fringe Benefits Tax

This submission addresses Part B of the Joint Committee of Public Accounts and Audit Inquiry reviewing a range of taxation issues within Australia, examining the application of the Fringe Benefit Tax (FBT) regime, including any "double taxation" consequences arising from the intersection of Fringe Benefits Tax and family tax benefits.

In particular this submission deals with the application of the Fringe Benefits Tax to business meals.

Fringe Benefits Tax is an inefficient tax

The tax system should strive to efficiently collect revenue without distorting business decisions. In a report for Restaurant & Catering Australia, Access Economics states that :

In simple terms, a completely efficient tax system is one in which the imposition of tax does not get in the way of – that is, distort – decisions made by businesses and individuals. If the tax system were perfectly efficient, decisions would not be affected by tax considerations at all. An investment that would proceed based on its before-tax rate of return would also proceed on the basis of its after-tax rate of return.

In the real world, all taxes are more or less inefficient. The primary task of tax policy reform therefore is to minimise the extent of those inefficiencies.

Sometimes economists and policymakers fall into the trap of thinking that improved economic efficiency is an end in its own right. In fact, improvements in efficiency are a means to an end; a means to stronger economic growth. That, too, is not really an end in itself, but rather a means to generate higher living standards.

These principles were also articulated in the Ralph Review as follows 'In raising revenue for the Commonwealth the business tax system should interfere to the least extent possible with the best use of existing national resources, with the efficient allocation of risk and with national economic growth in the longer term.

The present discriminatory taxation treatment of business meals – both in terms of the FBT component and the non-deductibility component, applying to business meals classified as business inputs into production – clearly violates this clear statement about the need for efficient allocation of resources because it distorts business decisions about production inputs. This Federal-level distortion is compounded at the State/Territory level because the non-grossed-up value of those business meals subject to FBT are also included in the payroll tax base as well (at least for larger businesses).

In its *Tax Blueprint* the Australian Chamber of Commerce and Industry cites FBT as 'the worst of all taxes from a compliance perspective' with 23% of revenue collected being expended on compliance.

In an Australian National Audit Office report released on the 2 June 2005 titled '*Administration of Fringe Benefits Tax'*, they concluded that 'complying with the requirements of FBT legislation can be relatively complex and resource intensive for many employers including Australian Government public sector entities.'

In the same report the ANAO found that the complexity was such that there is 'an increased risk that entities would not fully meet their FBT obligations'.

At every level, the taxation treatment of business meals fails the tests of good tax policy.

In its 2005 report for R&CA, Econtech found:

The third identified problem with the current legislation is that there is high compliance costs associated with the current legislation. This is because the current legislation is complex. That is, there are different FBT and tax deductibility rules depending on whether the meal is provided to employees or clients, and where the meal is provided. Table 1 below shows that different situations attract different tax treatment.

Table 1 outlines the different taxation treatments associated with the different types of business meals.

Table 1

Tax Treatment for Taxable Employers of Providing Food and Drink

Situation	FBT	Deduction
Consumed on employer's premises by employees:		
(1) At a social function	No	No
(2) At social function, in-house dining facility	No	No
(3) Not at a social function, in-house dining facility	No	Yes
(4) Morning/afternoon teas & light lunches	No	Yes
Consumed off employer's premises by employees:		
(5) At a social function or lunch including with associates	Yes	Yes
(6) By clients	No	No
Consumed by employees while traveling:		
(7) While travelling	No	Yes
(8) Employee travels with and dines with client	No	Yes

Source: Australian Taxation Office, Taxation Ruling TR 97/17

As shown in the table above, a meal provided to an employee on the employer's premises (say through an in-house canteen) is not subject to FBT, whereas a meal provided off-site (say at a restaurant) is subject to FBT.

Further complications arise through whether the meal is then tax deductible or not. If the meal is in-house and not a social function then it is deductible. In contrast, if it is in-house and at a social function then it is not deductible. Further, if it is off-site, regardless of whether it is classed as a social function or not, then it is deductible.

A more unified approach to taxing business meals would reduce complexity and the associated administration costs.

The major reviews of small business taxation and compliance costs, the *Bell (Time for Business) Review* and the *Ralph (Review of Business Taxation) Report* both recommended removal of FBT on business meals <u>due to the high compliance cost.</u>

The Bell Review detailed that:

Small business regards current rules and compliance costs in this area <FBT on Business Meals> as a nightmare. They require constant assessment of the circumstances under which meals are provided and detailed record-keeping. This can require small businesses to make distinctions between, for example, finger food, working lunches, and business entertainment, and the different circumstances under which these are offered, to calculate any FBT liability.

On the basis of the cost of compliance alone, the taxation treatment of business meals should be changed.

The Taxation Treatment of Business Meals is Discriminatory

The current taxation treatment of business meals discriminates against the suppliers of business meals over suppliers of other goods and services to business AND discriminates against SMALL BUSINESS.

The vast majority of business expenses are deductible. The basis of the assessment is the determination by the business that the expense was incurred in the pursuit of earning income to the entity conducting business. Business meals are different. The presumption is that the activity of having a meal with clients of a business is 'entertainment' and not business. In reality this is not the case.

In the report cited above, Access Economics stated:

Business meals:

- Are not part of an employee's remuneration as specified in employment contracts or as part of award conditions.

- Are necessary in many cases as part of the process of doing business – the fact that hundreds of millions of dollars of FBT revenue is collected in respect of such meals despite the punitive cost thereof (relative to other deductible inputs) attests to that reality. If FBT-liable meals or non-deductible meals were optional business inputs, no such activity would be undertaken, given the large tax distortions militating against them.

The Econtech report (cited above) found that:

The second identified problem with the current legislation is that it does not recognise that many business meals provided to employees are a necessary business expense. According to the Australian Taxation Office (ATO), businesses can "generally claim an immediate deduction for expenses that are necessary for the everyday running of your business"[1]. This means that businesses expenses are generally subject to a tax deduction, at the company tax rate of 30 per cent.

Many business meals are also an expense that is necessary for the running of a business. Therefore, it follows that these business meals should also be treated as a tax deductible expense. However, as shown in Table 2, under the current legislation some business meals are tax deductible while others are non-deductible. For business meals that are a necessary business expense, these meals should be treated in the same way as other business expenses and therefore made tax deductible.

Table 2

Current Legislation compared to Treating Meals as a Business Expense

	Current legislation
Individual's Income Tax Rate	
FBT rate	48.5%
Company Tax Rate	30%
GST rate	10%
FBT	$1.14
company tax	-$0.34
Total Tax	$0.80

source: Econtech

The current taxation treatment of business meals allows for 39 different treatments of a meal. The most stark discriminatory effect of the regime is that in-house meals (such as those provided in large multi-nationals' boardrooms) are, in the main, not subject to FBT and deductible, whereas, the same meals taken by a small business in a restaurant is subject to FBT and non-deductible.

The *Review of Business Taxation* found that 'The compliance costs associated with the Fringe Benefits treatment of entertainment are widely recognised as onerous and the consultation process <undertaken through the Ralph Review> evinced strong support from all quarters for simplifying current arrangements further'.

[1] http://www.ato.gov.au/businesses/content.asp?doc=/content/45586.htm

GST made FBT even more inefficient and <u>redundant</u>

FBT was originally introduced to protect the income tax revenue base and was levied on employers to streamline administration. The GST has made the administration a nightmare, even in the hands of employers and has reduced the need to broaden the tax base through FBT.

GST has dramatically increased FBT compliance cost. The Department of Foreign Affairs and Trade alone paid $25.7 Million in FBT in 1999-2000 with their FBT compliance increasing 129% as a result of GST[2].

The Access Economics Report compiled for Restaurant & Catering Australia in 2001 found that:

> The follow table replicates the table above, but allowing for the changes consequent on the introduction of the GST.
>
> **Table 3**

Net Cost To Business Of Different Business Expenses Post-GST

	Deductible Input	**Non-Deductible Input**	**FBT-Liable**
Input			
Basic cost	51.50	51.50	51.50
Cost Incl. GST	56.65	56.65	56.65
Grossing-up factor	1.00	1.00	2.13
FBT	0.00	0.00	58.50
Input tax credit (GST)		-5.15	0.00 -
5.15			
Gross cost	51.50	56.65	110.00
Income tax deduction(a)		-17.51	0.00 -
37.40			
Net cost to business	**33.99**	**56.65**	**72.60**

(a) Assumes company tax rate of 34%.

> As table 3 shows, the cost distortions for business meals relative to other business inputs under the GST have increased.
>
> For the 'client portion' of a business meal – in the post-GST world – the effective cost to a company paying company tax at the 34% rate is about 67% higher than for other (deductible) inputs. For the 'employee portion' of a business meal – in the pre-GST world – the effective cost to a company paying company tax at the 34% rate is almost 114% higher than for other (deductible) inputs. For a business meal where 'clients' and 'employees' meal costs are equal, the net cost of that expense, on average, is over 90% more than the net cost of a normal deductible expense. (Leaving the assumed company tax rate at 36% alters some of the precise numbers, but not the general conclusion that the introduction of GST makes the tax distortion against business meals worse than pre-GST.)

[2] A question on notice, in the Senate, 7 June 2000 to the Minister representing the Minister for Trade.

For any purely private meals, the cost changes suggested by the third column of table 3 make sense. But for business expenses there is no justification for increasing the cost discrimination against business meals, as indicated in columns two and three of table 3.

The Rationale For GST

When the Government first announced its tax reform package, and on a regular basis subsequently, it lauded the introduction of the GST, and its role as a replacement for some existing indirect taxes, because:

- The GST allowed the removal of a substantial Australian indirect tax burden on Australian exports.
- The GST allowed the removal of a substantial indirect tax burden on business inputs, allowing businesses to make decisions on such inputs less fettered by taxation considerations. This indeed is a move towards a more efficient taxation system, as indicated in Section 2 above.
- The replacement of the highly non-uniform Wholesale Sales Tax (WST) as part of the process helped to 'level the playing field' across different goods and services as well, making the indirect tax system less distorting and more fair, both for businesses and for consumers.

However, the hospitality industry has been a comprehensive net loser from indirect tax reform for three key reasons:

- Takeaway food and dining out is subject to GST, while much fresh food and some processed food sold in supermarkets is GST-free (the Democrat amendments).
- Meals purchased by overseas visitors to Australia (Food exports) are subject to GST here, while most exports are GST-free.
- Almost all business inputs allow business purchasers access to GST input tax credits (ITCs): however, for business meals, ITCs are available only if the purchase is grossed up and subject to FBT (the 'employee' portion); and no ITCs apply to non-deductible business meals (the 'client' portion).

The GST And Business Entertainment: Rationale Reversed?

Ironically, therefore, three of the key reasons for having a GST:

- levelling the indirect tax playing field;
- removing indirect taxes on Australian exports, and;
- removing indirect taxes on business inputs do not apply in the case of business meals in Australia.

On the contrary, the GST rationale in the case of business meals has been reversed:

- eating out has been made more expensive relative to other food;
- meals purchased by overseas visitors to Australia consumed in Australia are subject to GST while other exports are GST-free and also benefit from cost savings as a result of removal of WST and other indirect taxes;
- and business inputs in the form of business meals are made even more expensive, relative to other business inputs, than was the case before the GST was introduced.

The taxation treatment of business meals must be changed to return some fairness to the treatment of these expenses in the GST environment.

The International Experience

On the taxation the fringe benefits across the globe, the International Monetary Fund (IMF) said:[3]

> 'The treatment of fringe benefits varies greatly across income tax systems. Some income tax systems exclude all employer-provided fringe benefits from employee taxable income. Others impute some value for these fringe benefits and tax them at either the employer's tax rate or at the employee's tax rate. Still other tax systems deny a deduction at the company level for the cost of the fringe benefits.'

This great variation in the tax treatment of fringe benefits makes it more difficult to draw on a clear precedent. In a *The Case For, And Economic Effects Of, Part-Recognition Of Business Entertainment As Legitimate Business Inputs Or Expenses For Taxation Purposes*, Access Economics observes:

Typically, however, in most countries (other than Australia) :

- Business entertainment expenses are usually at least part-deductible, reflecting the acceptance that they are at least in part business-related and not 100% personal benefits.
- In many cases – including in the Asian region – they can be fully or largely deducted for income tax purposes.
- Where there are limitations on deductibility, substantiation requirements plus either a quantitative 'cap' on expenses, or some test of 'reasonableness' are used to apportion such expenses between business use and private benefits.

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3 *Taxation Policy Handbook*, edited by Parthasarathi Shome, Fiscal Affairs Department, International Monetary Fund, page 122.

In that report Access Economics concluded that 'In its tax treatment of business meals, Australian practice leads the world in complexity, inefficiency, and unfairness.[4]'

Overseas experience does not provide a uniform guide to 'best practice' in this area. However, most other countries either afford full- or at least part-recognition to business meals as a deductible business expense for tax purposes, rather than treating it largely as a fringe benefit.

The Way Forward

The *Bell Report*, the Ralph Review, the *Access Economics Report (The Case For, And Economic Effects Of, Part-Recognition Of Business Entertainment As Legitimate Business Inputs Or Expenses For Taxation Purposes*) and the Econtech Report (*Analysis Of Reforms To Tax Legislation Relating To Business Meals*) all essentially recommended the same way forward.

This is probably best articulated in the Ralph Review recommendations, as follows:

Business entertainment expenses

Non-deductibility of business entertainment expenses

(a) That business entertainment expenses incurred by taxable employers be removed from fringe benefits coverage and made non-assessable in employees' hands and non-deductible to employers as from, and including, the 2002-03 income year.

Definition of business entertainment expenses

(b) That this treatment:

(i) apply to business-related entertainment expenses in relation to restaurant and catered meals, admissions to functions and the provision of venues and associated costs for business-related functions; and

(ii) exclude private functions such as weddings, anniversaries, birthdays and the like, with a non-exhaustive list of these private functions to be incorporated into the tax law — with such fringe benefits taxable to employees and deductible to employers.

4 See also *Fringe Benefits Tax: Time For A Rethink* Geoff Carmody, Australian Tax Research Foundation, Research Study No. 29, especially pages 45-53.

Entertainment allowances to be employee income

(c) That entertainment allowances provided to employees in advance of expenditure be treated as another form of remuneration and be deductible to employers and taxable to employees.

Treatment of exempt bodies

(d) That, for administrative simplicity, the treatment in paragraphs (a), (b) and (c) apply to exempt bodies in respect of entertainment which currently attracts FBT.

Two exceptions will need to be made — having significant compliance benefits — to the general recommended approach of taxing fringe benefits in the hands of the employee. The first refers to the treatment of employee costs associated with entertaining business clients.

The compliance costs associated with the fringe benefits treatment of entertainment are widely recognised as onerous and the consultation process evinced strong support from all quarters for simplifying current arrangements further. Attributing a share of entertainment costs to individual employees would only exacerbate compliance costs — as is already recognised in the design of the reporting requirements in *A New Tax System*. Under these requirements, entertainment by way of food and drink or hire and lease of entertainment facilities is excluded from the group certificate reporting measure because of the high compliance costs involved.

A much simpler alternative — Recommendations (a) and (b) — is to remove business entertainment fringe benefits from fringe benefits coverage and to treat client and employee entertainment expenses in a consistent manner by making both non-deductible business expenses for employers. In essence, the Review recommends a return to the treatment of entertainment that applied before 1995. But a need has been identified to be more prescriptive in guarding against exploitation of concessional treatment of private entertainment (effective taxation at the employer’s rate rather than the employee’s) to minimise the effects on government revenue.

The approach recommended by the Review is a compromise which allows employers to deal in a consistent manner with the entire costs of a wide range of business related events. For example, if business is conducted with clients in a restaurant, the boardroom or in a corporate box, or as part of a catered promotional launch in a marquee, none of the meal and other entertainment costs will be regarded as fringe benefits. As an offset, no deduction will be allowed to the employer against income tax for any of the costs.

This approach removes any need for employers to keep records of attendance at functions and to separate the different cost components. This will significantly reduce compliance costs for business and simplify the administration of the taxation system. Examples of the current and recommended treatment of entertainment expenses for taxable entities are set out in Table 4 below.

Recommendation (b)(ii) will give rise to a list of private functions to be excluded from being non-taxable fringe benefits. Such a list will make it easier for business and the ATO to identify the boundary between business-related entertainment and entertainment that is essentially of a private nature.

Under Recommendation (c), entertainment allowances provided ahead of any expenditure to employees will be taxed like other forms of income of the employee. This will guard against employees switching salary into an entertainment allowance in order to benefit from any difference between their marginal tax rate and the loss of deductibility of entertainment expenses to the employer. Having employees seek reimbursement or requiring the employer to pay direct will create a more traceable record of business-related entertainment expenses than would occur with the use of entertainment allowances.

Table 4

Treatment of entertainment expenses — some examples

Situation	Current treatment	Recommended
Employee takes two clients to lunch in a restaurant — cost $150	FBT applies to employee's portion ($50) and is tax-deductible. Clients' portion is non-deductible.	All $150 treated as a non-deductible business expense. No fringe benefit treatment.
Employer provides employees, clients and associates with theatre tickets	FBT applies to employee and associates' share and is tax deductible. Client share is non-deductible.	Non-deductible. No fringe benefit treatment.
Employer provides food and drink during working hours at a social function for employees and associates in office	Employee share is non-deductible while FBT applies to associates' share and is tax deductible	Non-deductible. No fringe benefit treatment.
Employee has meal in an 'in-house' canteen or in a restaurant while travelling on business	Exempt from FBT and tax deductible	Still not a fringe benefit and so tax deductible

The Economic Effects of Two Alternative Policy Options

The Econtech Report (*Analysis Of Reforms To Tax Legislation Relating To Business Meals*) compare the above recommendations with previous proposals to make business meals 50% deductible and FBT free.

The report explained that employee meals should be taxed in two ways:

1. Business related meals should be taxed under the Business Expense option; and
2. Private meals should be taxed in the hands of the employee.

However, this would only add to the third problem with the current legislation – that of complexity. One option, the Ralph Review option, provides a midpoint between the current over-taxation of business related employee meals and the option of treating all meals provided to employees as pure business expenses.

Given the considerations discussed above, Econtech has modelled three policies.

- The current legislation has been modelled as the "baseline scenario".
- The "Ralph Review" and "Business Expenses" options have been modelled as alternative policy options.

To analyse the impact of changing the legislation, Econtech has then compared the results of the alternative scenarios with the current legislation. This means that the costs and benefits of reforming the current policy to one of these alternative policies are included in the modelling results.

- The Ralph Review proposal is modelled because it addresses the three key problems with the current legislation.
- The Business Expenses Option has also been modelled. It also addresses the problems identified with the current legislation.

To model the scenarios, Econtech has constructed a custom-built model to identify the direct impacts of each policy. In addition, Econtech has used its MM600+ model to identify the flow-through or indirect impacts on the rest of the economy.

The custom-built model is used to model the differences in tax collections and the cost of business meals under various policy options. Inputs into the model include alternative assumptions about the following variables:

- Rates of taxation in terms of FBT, GST, company tax and income tax.
- The extent to which meals are tax deductible.
- Who the tax burden from meal purchases is applied to. For example, you can choose between 'companies paying FBT' and 'meals taxed in the hands of the employee'.

Results from the custom-built model were used in the option discussions above and in estimating the direct budget impacts of each alternative policy.

MM600+ is used to model the economy-wide and industry-wide impact of taxation reforms. Econtech's MM600+ model is a long-term computable general equilibrium (CGE) model of the Australian economy. MM600+ covers industry costs and prices as well as industry production and employment, and models market-clearing, long-term outcomes under optimising behaviour.

MM600+ distinguishes 672 products, making it six times more detailed than any comparable model. It achieves this high level of detail using unpublished input-output data obtained in an electronic format from the Australian Bureau of Statistics (ABS). So MM600+ provides highly detailed product results at the national level. These results cover production, employment, pricing and trade flows.

Direct Impact on the Government Budget

This section examines the direct effect of the two alternative policy options on the Government budget. While the previous section examined the impacts for every $1 worth of meals (excluding GST), this section puts these costs into perspective.

The first step in this analysis is to examine the contribution that FBT on meals for employees makes to total FBT collections. Detailed Table 4 in Chapter 12 of the *Australian Taxation Office's (ATO's) 1998-99 Taxation Statistics* publication[5] shows that the total FBT collected for meals/entertainment was around $269 million for the 1999-00 income year.

To estimate the impact in the 2005-06 financial year, the $269 million was inflated to 2005-06 dollars using an estimated change in nominal GDP over the same period, as shown in Table 5. This gave an estimated $394 million in FBT collections on meals/entertainment for the 2005-06 financial year.

Table 5

Estimating FBT Collected and Total Amount Spent on Employee meals

	$ million
FBT collected on business meals in 1999-00 (1)	269
Nominal GDP in 1999-00	623,549
Estimated Nominal GDP in 2005-06 (2)	911,998
FBT collected on business meals in 2005-06	394
Meals/Entertainment FB Grossed-up amount	812
FBT Rate	48.5%
GST Rate	10%
FB Gross-up Rate	213%
total cost of business meals incl. GST	381
total cost of business meals excl. GST	347

(1) "business meals" refers to the "meals/entertainment" category in the ATO's Taxation Statistics publication. It does not include the separate "entertainment" category.
(2) Sourced from Econtech's MM2 forecasting tool. See http://www.econtech.com.au for more information.

Using the FBT Gross-up rule[6], the total cost of meals/entertainment which will attract FBT in 2005-06 has been estimated at around $347 million (excluding GST).

[5] ATO, *Taxation Statistics 1998/99*, (http://www.ato.gov.au/content/downloads/99fbt04.pdf)

[6] Gross-up rate = (FBT rate + GST rate)/((1-FBT rate) x (1+GST rate) x FBT rate) = 2.13; and

FBT = Gross-up rate x fringe benefits amounts x FBT rate = 2.13 x fringe benefits amounts x 48.5%.

By holding constant the consumption of these meals/entertainment and applying the two different policy scenarios, we can then estimate the direct impact of each scenario on the Government budget.

Table 6 shows the total estimated direct effect on the Government budget. The two alternative policies will impact on the Government budget through changes in FBT, GST and company tax collections.

Table 6

Direct Effect on the Government Budget

	Current	Ralph	Business
total cost of business meals excl. GST ($m) (1)	$347	$347	$347
GST ($m)	$35	$35	$35
total cost of business meals incl. GST ($m)	$381	$381	$381
GST credit	$35		$35
business meals FB Grossed-up amount	$812	$812	$812
FBT collected on business meals ($m)	$394	$0	$0
tax deductible expense ($m)	$741	$0	$347
company tax saving ($m)	-$222	$0	-$104
Total tax ($m)	$172	$35	-$104
change in FBT collected on business meals ($m)		-$394	-$394
change in company tax collected ($m)		$222	$118
change in non deductible GST ($m)		$35	$0
change in tax compared to Current Legislation ($m)	$0	-$137	-$276
change in tax compared to Business Option ($m)	$276	$139	$0

(1) "business meals" refers to the "meals/entertainment" category in the ATO's Taxation Statistics publication. It does not include the separate "entertainment" category.

Under both options, FBT is removed from employee meals. In our example above, this is estimated to cost the government $394 million dollars in FBT taxation revenue in 2005-06.

Under the Ralph option, this loss in FBT revenue is somewhat offset by an increase in both company tax and GST collections. These are the result of removing the ability of businesses to continue to claim the cost of these meals (and the FBT on these meals) as a deductible expense for taxation purposes.

Without the ability to claim these expenses, this increases the company tax collected from businesses by $222 million [30% x ($347 + $394)]. Further, if an expense is non-deductible for taxation purposes, then a business is also not entitled to claim the GST as an input tax credit. Thus, this increases the GST collected by the Government by $35 million (10% x $347).

Overall, the Ralph option is estimated to lead to a reduction in direct government tax receipts of $137 million compared to under the current legislation ($394 - $222 - $35).

Taking this proposal one step further, the Business Expense option treats all employee meals as a business expense. As well as removing the FBT on these meals, this option allows businesses to continue to claim the cost of these meals as a deductible expense for taxation purposes. This means that there is only a slight offsetting effect from an increase in company tax collections.

Under the current legislation, FBT costs are also tax deductible expenses. Thus, with the removal of FBT under the Business Expense option, this reduces the amount of business tax deductible expenses by the amount of the FBT. That is, the amount of expenditure that is tax deductible is now reduced by $394 million. Without the ability to claim the FBT as an expense, this increases the company tax collected from businesses by $118 million (30% x $394).

Overall, the Business Expense option is estimated to lead to a reduction in direct government tax receipts of $276 million ($394 - $118) compared to the current legislation. This is approximately twice the estimated reduction in tax receipts under the Ralph Review option.

This section only examines the <u>direct</u> effect of the two alternative options on the Government budget. The modelling in the following section examines the <u>total</u> effect. The analysis of the total effect makes the standard assumption that in the long-run the Government budget must be balanced. This is because a budget deficit is not sustainable in the long-run. This is discussed in more detail in the following section.

The last row in Table 6 shows that, if all employee meals are business related, then the current legislation is expected to collect $276 million dollars in excess taxation in 2005-06, compared to if the legislation treated these meals as pure business expenses.

The Ralph option provides a midpoint between the current over-taxation of business related employee meals ("Current Legislation") and the option of treating all meals provided to employees as pure business expenses ("Business Expense option"). The Ralph option shows the amount of over-taxation reducing to around half of the amount estimated under the Current Legislation.

Economy-wide Impacts of the Two Alternative Policy Scenarios

The economic modelling of the economy-wide effects of the two alternative policies was conducted using Econtech's MM600+ model. MM600+ is a long-term CGE model of the Australian economy that models a long-run equilibrium. MM600+ is highly detailed, distinguishing 672 products produced by 108 industries. This makes it six times more detailed than any comparable model.

MM600+ has many features as follows:

- it fully incorporates the New Tax System (NTS) and models the GST treatment of each of its 672 products, and 24 other indirect taxes;
- it allows for substitution effects triggered by changes in the prices of goods & services. For example, MM600+ allows substitution between:
    - labour and capital;
    - different types of capital inputs such as motor vehicles, computers, buildings etc;
    - different forms of primary energy, including black coal, brown coal, and LPG;
    - local and export destinations for sales; and
    - imports and local sources of supply of goods and services.
- it is set up to achieve budget neutrality in alternative ways. The default swing fiscal instrument, which is used in this report, is income tax, and the alternative swing fiscal instrument is GST;
- it provides valid measures of changes in consumer living standards based on compensating variations so that possible tax scenarios can be correctly evaluated in terms of the public interest.

MM600+ models a long-run equilibrium. In the long-run, economic agents optimise, all markets are in equilibrium, and assets and liabilities follow sustainable paths. Some of the key assumptions of particular interest for this analysis are as follows.

- Budget balance: in the long-run the government budget must be sustainable. This means that in MM600+ the government budget is assumed to be in balance in the long-run. Thus, in this analysis it is estimated that the Government will use labour tax receipts to finance this proposal.
- Labour market equilibrium: in the long-run the labour market is assumed to attain equilibrium, so that economic shocks, such as changes in production levels in one industry, have no lasting effect on total employment. Rather, only the distribution of total employment across industries is affected.

For more information on MM600+, download the model documentation from Econtech's web-site (www.econtech.com.au).

To examine the two alternative policy options, Econtech has modelled two scenarios.

- Baseline Scenario – this scenario models the Australian economy under the current tax arrangements. Specifically, the baseline scenario assumes that meals provided to employees attract FBT. The baseline is modelled in MM600+ by applying a production tax on 'meal preparation and presentation' equal to the amount of tax estimated in the last row of Table 6 (that is, $276 million).
- Ralph Review Scenario – under this scenario, the removal of FBT on meals provided to employees is expected to boost demand in the Accommodation, Cafés & Restaurants industry. However, this will be somewhat offset by not allowing these meal costs to be claimed as a tax deductible expense. This option is modelled in MM600+ as a reduction in the production tax on 'meal preparation and presentation' that was applied under the baseline. This will reduce the costs in the industry, which will reduce the price of prepared meals, which, in turn, will boost demand for these services. It is assumed that the Government finances this proposal through labour income tax receipts.
- Business Option Scenario – under this scenario, demand in the Accommodation, Cafés & Restaurants industry is expected to be further boosted by allowing meals provided to employees to be both FBT free and tax deductible. This option is modelled in MM600+ by removing the production tax that was applied under the baseline.

The two alternative scenarios are then compared to the Baseline Scenario to examine the impact of changing the legislation.

Impact on the Accommodation, Cafés and Restaurants Industry

The two alternative taxation policies regarding employee meals are both expected to boost production and employment in the Accommodation, Cafés and Restaurants industry. This is because the changes in the tax treatment of these business meals will reduce the price of these meals to businesses, therefore stimulating additional demand for these products.

Figure 1 shows the estimated effect on employment and output in the Accommodation, Cafés & Restaurants industry.

Figure 2 shows the Change in Employment and Output in the Accommodation, Cafés and Restaurants Industry.

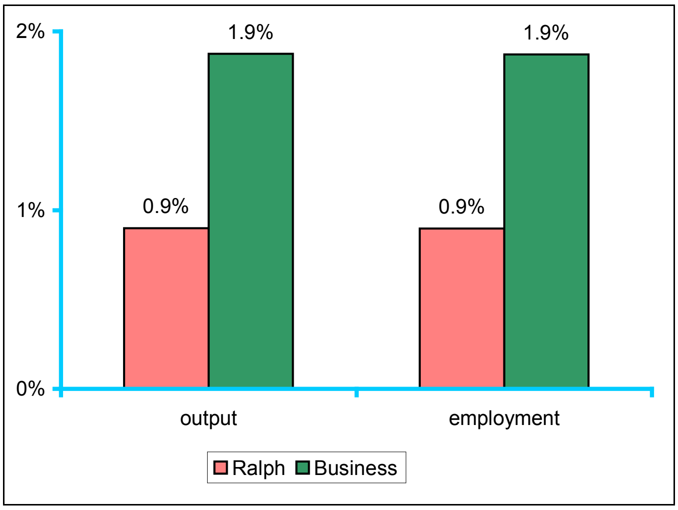

Figure 1 - estimated effect on employment and output in the Accommodation, Cafés & Restaurants industry

The two alternative options are both expected to boost activity in the Accommodation, Cafés and Restaurants Industry. The chart above shows that output is expected to increase by 0.9 per cent under the Ralph option and 1.9 per cent under the Business option. Similarly, employment in this industry is expected to rise by around 0.9 per cent and 1.9 per cent under the Ralph and Business options, respectively.

Industry-wide Production and Employment Effects

While the alternative options affect the distribution of employment across industries, the level of employment across the whole economy is not expected to change under either option.

As discussed above, the modelling assumes labour market equilibrium. Changes in industry specific taxation policy, such as this, are therefore not assumed to create new jobs. National employment or unemployment remains unaffected because they both depend on the overall efficiency of the national labour market, which is assumed to be unaffected by this particular taxation policy. So, only the distribution of total employment between industries is affected.

It is important to analyse economic policies using a long-run model that generates sustainable outcomes. In contrast, short-term models, such as standard input-output models, often generate estimates of gains that are not sustainable, leaving an unjustifiably rosy impression of the policy proposal that is being modelled.

The Accommodation, Café and Restaurant industry is important as a major source of new jobs. Since November 1984, employment in this industry has risen almost 140%, compared with a rise in total employment in all industries of just under 50%.
The Ralph and Business options are expected to further boost employment in this industry by about 800 and 1,600 people or 0.3% and 0.6%, respectively.

Some of the broad industries that show a fall in employment and production have within them items whose production is boosted by the increase in café and restaurant activity. Examples of some of these related products are shown in Figure 2 below.

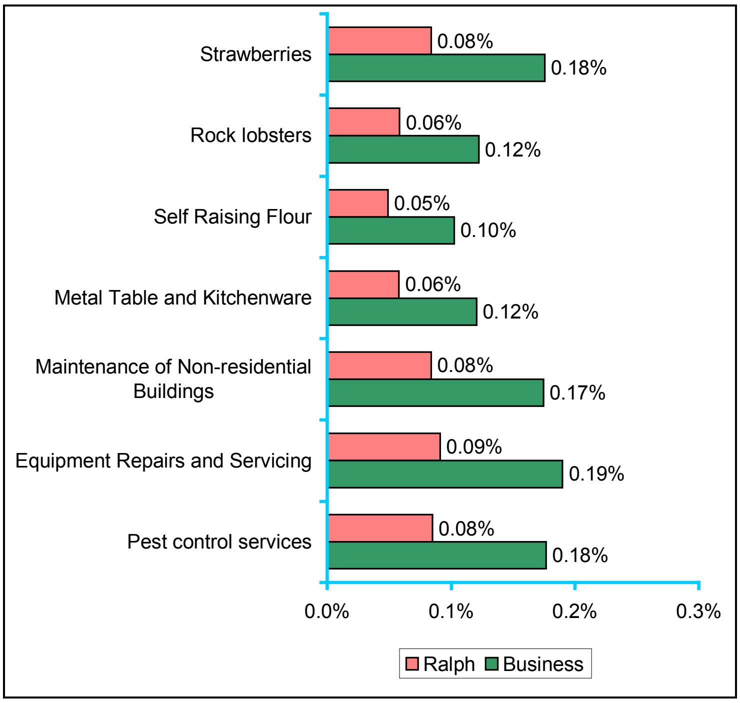

Figure 2 - Effect on the Output of Related Products

The chart above gives some examples of the increase in the production of products that are supplied to the Accommodation, Cafés & Restaurant industry. These products include fresh fruit, seafood, other food products, tableware and some business services. Output in these product groups are expected to increase by between 0.05% and 0.19%.

Total Budget Effects

As shown above, the Ralph option and the Business Expense option are both expected to directly lead to a reduction in taxation revenue of $137 and $276 million dollars, respectively. In addition to these direct effects, there will also be indirect effects on the budget, resulting from the increase in the consumption of business meals and changes in production and employment across industries.

Figure 1 showed that the two alternative options are both expected to boost activity in the Accommodation, Cafés & Restaurant industry, with output expected to increase by 0.9% under the Ralph option and 1.9% under the Business option. This equates to an increase in consumption of meals of around $64 million and $133 million under the Ralph and Business options, respectively.

Table 7 shows this increase in the value of meals purchased and also the total estimated effects on the government budget. As discussed above, the long-term modelling in MM600+ assumes that the government will use labour tax receipts to finance the alternative options. This is discussed in more detail below.

Table 7

Total Government Budget Effects ($ million)

	Ralph	Business
Impact on Consumption of Meals		
increase in business meals excl GST	64	133
increase in GST	6	13
increase in total cost of business meals incl. GST	70	146
Change in Government Budget Receipts		
Fringe Benefits Tax (as discussed in Section 4.1)	-394	-394
Company Tax (as discussed in Section 4.1)	222	78
GST		
Business Meals (as discussed in Section 4.1)	41	0
Change in GST Collections - Other	-49	-15
Labour income tax and other tax revenue		
Accommodation, Cafés & Restaurants industry	154	170
Other (to attain budget balance)	25	161
Total Budget Effects	0	0

Table 7 shows that FBT receipts are expected to fall by around $394 million as a direct result of the removal of FBT on business meals. This was discussed above and is shown in the first row of the table above. The resulting additional expenditure on meals will not affect this change in FBT collections.

In contrast, company tax receipts are expected to rise under both scenarios as fewer costs are able to be claimed as tax deductible expenses, as discussed above. For the Ralph option, additional expenditure on meals will not affect the change in company tax collected, as these meals are non-deductible for taxation purposes.

For the Business Expense option, the increase in meal consumption will reduce the direct change in company tax by $40 million – from $118 million (as shown in Table 6) back to $78 million. This is because businesses are spending additional money ($133 million) on deductible expenses, thereby reducing their before tax profit. This in turn reduces their company tax liability (30% x $133 = $40).

Further tax effects are expected through GST collections. As discussed above, under the Ralph proposal, the GST paid on a meal would not be eligible as an input tax credit. Thus the amount of GST receipts from business meals increase by around $41 million under this option ($35 million from Table 6 plus an additional $6 million, as shown in the third row of Table 7).

On the other hand, GST collections are expected to be lower in other areas of the economy. It is expected that the proposal will lead to a substitution of spending towards meals and away from other goods and services across the economy. As a result, the GST collections on other goods and services are expected to be lower.

Finally, income tax collections are also expected to change under both options. With an increase in consumption of restaurant meals, employment in the Accommodation, Cafés & Restaurant industry is expected to increase. Based on the average wage in this industry, income tax receipts from this boost in employment are expected to contribute an additional $154 million in income tax revenue under the Ralph option and $170 million under the Business option.

Further, as mentioned previously, it is assumed that the Government budget is in balance in the long-run. This is because a budget deficit is not sustainable in the long-run. The net cost of the chosen option is expected to be financed by the Government through income tax receipts. Thus, the increase in other income tax revenue (row 14 in Table 2 above) is expected to exactly offset the change in tax revenue from all other sources.

Summary

Restaurant & Catering Australia believes that it is well documented and well understood that the taxation treatment of business meals, specificially the FBT on businesses meals, is a most inefficient tax.

The Association believes that it has been proven that the taxation treatment of business meals discriminates against small business. It does so by taxing business meals for small businesses yet leaving a loop hole where big business is still able to deduct expenses incurred through in-house dining facilities.

Further, GST has made this situation worse by dis-allowing input credits for non-deductible expenses. On top of the additional gap between the cost of in-house meals and a meal in a restaurant, created by food being made GST exempt, this means that the tax that was not to be a tax on business WAS A TAX ON BUSINESS MEALS.

Every report into compliance costs and FBT has agreed that business meals should be removed from the FBT net. This report suggests that the Ralph Review recommendation be adopted :

That business entertainment expenses incurred by taxable employers be removed from fringe benefits coverage and made non-assessable in employees' hands and non-deductible to employers.

Ralph Review of Business Taxation, 1999