

Introduction

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

Conduct of the inquiry

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

Past and current inquiries

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

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

Work-related expense (WRE) deductions for individuals

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

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

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

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

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

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

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

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

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

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

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

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

Table 1.1 International comparisons of deductions for WREs

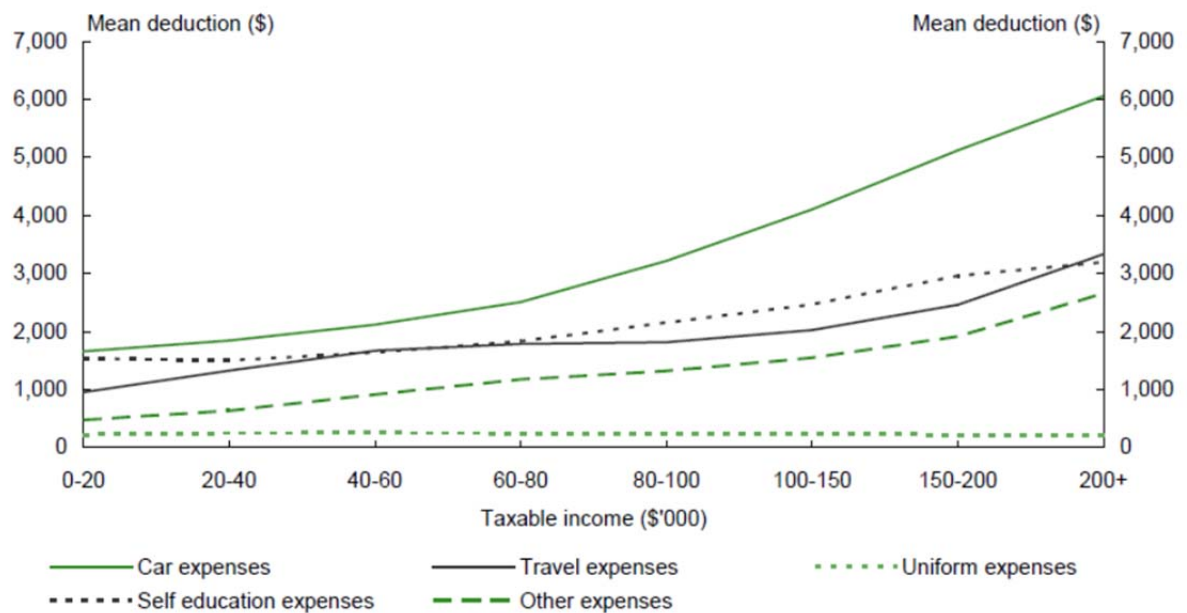
Country	Deductions for work-related expenses	Scope of deductions and arrangements
Australia	Yes	Incurred in gaining or producing an employee's assessable income.
Canada	Limited	Only deductions specifically legislated are allowed, for example, work supplies that you must provide and pay for under your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

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Interest deductibility in company income tax

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Business Tax Working Group – November 2012

Interest deductibility in company income tax

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

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

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

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

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

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

Re: think Tax Discussion Paper – March 2015

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

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

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

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

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

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

Work-related expense deductions for individuals

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Interest deductibility in company income tax

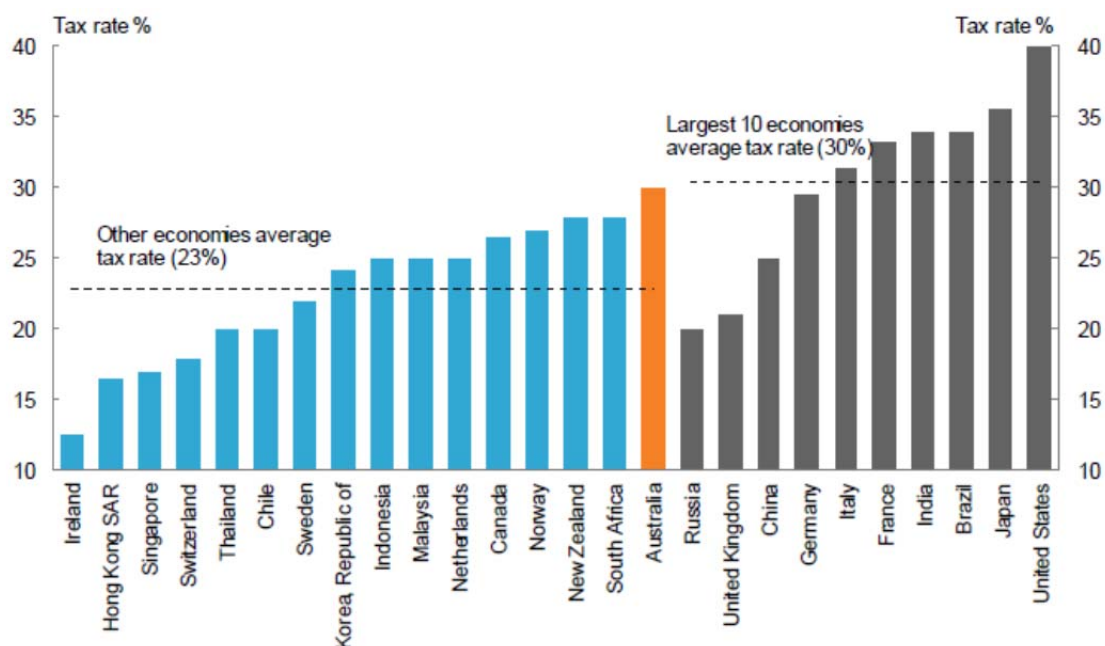
- 1.46 Prior to recent reductions in the small business tax rate all Australian companies were levied at 30 percent. *Re: think* reported in 2015 that Australia's corporate tax rate is higher than many countries that Australia competes with for investment.⁴⁷ *Re: think* compared corporate tax rates for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

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

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

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

Figure 1.2 Corporate tax rates, selected trading partners, 2014



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

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

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

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

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

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

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

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

Australian tax deductions

What is a tax deduction?

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

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

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

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

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

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

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

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

Personal tax deductions

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

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

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

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

1.58 Examples of non-work-related expenses include:

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

Business tax deductions

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

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

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

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

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

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

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

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

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

Table 1.5 Individuals - Selected Deductions - % shares of totals

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

Source Taxation Statistics, Calculations by Parliamentary Library.

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

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

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

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

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

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

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

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

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

Objectives, scope and focus of the inquiry

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

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

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