



Australian Government

The Treasury

Standing Committee on Economics

The Department of the Treasury's submission to the
inquiry into tax deductibility

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Introduction

1. Australia's tax system comprises a number of taxes and is generally broad based. Major taxes levied at the Commonwealth level are personal income tax, company income tax, capital gains tax (which is included within the income tax system), fringe benefits tax (which is paid by companies) and the goods and services tax (GST), which is distributed to the states and territories.
2. The Australian income tax system captures most forms of income and operates differently for individuals and companies. It approximates a comprehensive income tax base and generally provides a full deduction for expenses and losses incurred in gaining tax assessable income. However, unlike a fully comprehensive income tax base it does not tax imputed rents or recognise capital gains as they accrue to the taxpayer.
3. 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.
4. 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 to provide assistance to particular groups of taxpayers or support particular economic activities and for ease of administration.
5. Australia, for instance, modifies the timing and recognition of certain forms of income (capital gains) and expenses (borrowing costs) and also taxes individuals and companies differently with individuals paying tax according to an increasing tax scale as a way of ensuring people with higher taxable incomes pay a higher average rate of tax. New Zealand does not tax most capital gains or provide deductions to individuals for expenses incurred in earning assessable income. These departures arguably simplify the tax system and allow for a lower personal tax rate. New Zealand also has a 'flat' personal income tax schedule, with a relatively low top marginal tax rate.

Individuals

What are personal tax deductions?

6. Deductions are broadly defined as costs that are incurred in producing assessable income. The general deduction provision under the Australian income tax law allows personal tax deductions for expenses that individuals incur in gaining their personal non-business income (for example, salary and wages, rent, interest or net capital gains from investments), other than expenses that are capital, private or domestic in nature.¹
7. Personal deductions available under the general deduction provision are usually classified as work-related expenses (WREs) or investment-related expenses. The law also provides for specific deductions which may not fall within the general deduction provision. A full list is available from the Australian Taxation Office (ATO) website:
www.ato.gov.au/Individuals/Income-and-deductions/Deductions-you-can-claim/
8. The ability of individuals to claim WRE deductions does not restrict employers from providing work-related benefits to their employees. In fact, benefits provided to employees that would be deductible as a WRE if purchased by the employee are generally not subject to fringe benefits tax. However, if a benefit is provided to an employee for private or domestic purposes, the benefit is generally treated as a form of remuneration and subject to fringe benefits tax. For example, if an employer pays for an employee's home phone bill, and the home phone is used exclusively for private purposes, the payment is likely to be subject to fringe benefits tax.

What kinds of personal tax deductions are there?

General deductions

Work-related expenses (WREs)

9. Individuals are able to claim deductions for a broad range of WREs.² These include self-education expenses, vehicle and travel expenses, clothing and laundry expenses and home office expenses. Where an expense has both a work and a private element, the expense must be apportioned and only the work-related element claimed as a deduction.

Investment-related expenses

10. Investment-related expenses are those incurred in producing investment income. They can include management fees for an investment, account-keeping fees, insurance, land tax, depreciation, maintenance expenses, and interest on borrowings used to purchase an income-producing asset.
11. A lot of investment-related deductions claimed in the personal income tax system relate to rental properties. A property is said to be 'negatively geared' when the mortgage interest repayments exceed the net rental income from the property.³ Negative gearing is consistent

¹ Section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 97).

² Australian Government 2015, *Re:think Tax Discussion Paper*, page 54.

³ Australian Government 2015, *Re:think Tax Discussion Paper*, page 64.

with the broader operation of Australia’s tax system in allowing deductions for expenses incurred in producing assessable income. These arrangements are not exclusive to property, and other assets such as shares can also be negatively geared.

12. The *Re:think Tax Discussion Paper* contains a chart showing the expenses (deductions) claimed for rental properties as a proportion of gross rental income over time from 1997-98 to 2011-12.⁴ Since 2000-01, total deductions for investment properties have exceeded gross rental income. More recent data from the ATO’s *Taxation Statistics 2012-13* shows gross rental income and rental deductions for the three income years up to 2012-13. Claims for rental interest deductions were made by 12 per cent of all taxfilers in the 2012-13 income year. 82 per cent of individuals investing in property deducted interest from their rental income.

Table 1: Individuals – rental income and deductions, 2010–11 to 2012–13 income years

	<u>2010–11</u>		<u>2011–12</u>		<u>2012–13</u>	
	no.	\$m	no.	\$m	no.	\$m
Gross rental income	1,788,690	30,730	1,873,210	34,000	1,944,080	36,593
Rental interest deductions	1,459,530	22,670	1,532,300	24,178	1,591,610	22,548
Capital works deductions	734,565	1,921	798,075	2,167	857,975	2,440
Other rental deductions	1,795,705	14,002	1,880,845	15,531	1,952,530	16,998
Net rental income*	1,811,175	-7,862	1,895,775	-7,860	1,967,260	-5,394

*Components do not add to the total number of taxpayers because taxpayers may claim more than one type of deduction.

Source: ATO 2015, *Taxation Statistics 2012-13*.

Specific deductions

13. Section 12-5 of the *Income Tax Assessment Act 1997* (ITAA 97) provides a list of specific deductions. These include the cost of managing tax affairs (for example, costs to prepare a tax return); gifts to deductible gift recipients (subject to certain conditions);⁵ union dues and subscriptions to trade, business or professional associations;⁶ and a cents per kilometre valuation method for car expenses.⁷

Commonly-claimed personal tax deductions

14. The Australian Government’s *Re:think Tax Discussion Paper* provided a chart showing the major sources of assessable income, non-assessable income and deductions reported in Australia’s individual income tax returns in 2011-12.⁸ More recent data shows selected deductions for the three income years up to 2012-13. The data indicates that WREs are the most commonly claimed deductions for individuals. In 2012-13, 66 per cent of individuals filing a tax return claimed a deduction for WREs, with an average claim of approximately \$2,300.

⁴ Australian Government 2015, *Re:think Tax Discussion Paper*, pages 64-65 (Chart 4.2).

⁵ Division 30 of the ITAA 97.

⁶ Section 25-55 of the ITAA 97. The deduction (up to \$42) is available in addition to any ‘general’ WRE deduction.

⁷ Division 28 and Subdivision 900-C of the ITAA 97. This method is an alternative to the logbook method which is based on actual expenditure.

⁸ Australian Government 2015, *Re:think Tax Discussion Paper*, page 50 (Chart 3.6).

Table 2: 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
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
Interest deductions*	481,785	1,299	437,125	1,144	370,655	917
Total deductions[#]	na	27,285	na	28,317	na	28,475

* Interest deductions relate to expenses incurred in producing interest income, and may include investment management fees or bank account fees. This does not include rental interest deductions.

Components do not add to the total number of taxpayers claiming deductions because some may claim more than one type of deduction.

Source: ATO 2015, Taxation Statistics 2012-13.

International comparisons

Work-related expenses

15. Australia’s tax system is relatively generous in respect of WRE deductions. The approaches of some comparable countries are more prescriptive or limited.⁹

Table 3: Deductibility of work-related expenses for selected OECD countries

Country	Deduction for WREs?	Comment
Australia	Yes	Deductions allowed for expenses incurred in gaining or producing assessable income.
Canada	Limited	Only specifically legislated deductions are allowed, for example, work supplies that you must provide and pay for under your contract of employment.
Japan	Limited	Only specific deductions above a standard amount for employment income are allowed.
Netherlands	Limited	OECD 2015: Specific deductions permitted; various thresholds and caps apply.
New Zealand	No	No deductions for WREs for employees.
Spain	Standard deduction	A general standard deduction for WREs is available, which decreases as income increases.
Switzerland	Limited	OECD 2015: Taxpayers are allowed a deduction corresponding to 3 per cent of net income. This deduction may be no less than CHF 2000 and no more than CHF 4000.
United Kingdom	Yes – narrow	Most deductions in the United Kingdom 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. OECD 2015: Flat rate expenses for tools and special clothing are allowed to certain occupational categories.
United States	Limited	Employees can deduct WREs subject to limitations (expenses generally only deductible to the extent they exceed 2 per cent of adjusted gross income). The United States allows taxpayers the option of claiming a standard deduction in lieu of itemising deductions.

Source: Australian Government 2006, *International Comparison of Australia’s Taxes*, updated where possible with information from OECD 2015, *Taxing Wages 2015*.

16. As illustrated in Table 3, the United Kingdom specifies a tighter nexus on WREs. WRE claimants in the UK are given an option of claiming a standard deduction based on their occupation, without having to substantiate their claim with records. Alternatively, employees may make a

⁹ Australian Government 2015, *Re:think Tax Discussion Paper*, page 54.

claim for the amount actually spent on eligible items, however this requires substantiation and must satisfy the test of being incurred ‘wholly, exclusively and necessarily in the performance of an employee’s duties’. Guidance on which expenses may satisfy the test is provided on UK Government websites¹⁰ and has also been tested by case law. In practice, the test is stringent because it involves several legs, all of which must be individually satisfied. For example, one part of the test specifies that a WRE is only deductible if it need be incurred by every holder of that form of employment – it is not enough that one employee, or a subset of employees, happens to incur the expense. Whilst the UK approach does not reduce the compliance burden for those people who specifically claim WRE deductions, it does narrow the deductions that may be claimed, which may in turn reduce the number of WRE claimants and the aggregate compliance burden imposed by the tax system.

17. By contrast, New Zealand does not allow any WRE deductions for employees. The abolition of WRE deductions occurred in the late 1980s and was accompanied by income tax cuts. This has been a major driver of compliance savings by reducing the number of people required to file a tax return – in the 2012 tax year, around 1.25 million individual tax returns were filed out of an estimated 3.3 million individual taxpayers.¹¹ By contrast, in Australia, in the 2012-13 income year, 12.8 million individuals lodged tax returns out of 14.6 million working-age individuals.¹²

Investment-related expenses

18. Some countries¹³ operate variants of a dual income tax system, which separates labour and capital income. Under a dual income tax system, allowable deductions relating to capital income can usually only be deducted against capital income, and not against salary and wage income.¹⁴
19. In the UK, expenses incurred in buying and selling shares, such as stockbroking fees, can be deducted from any gain subject to capital gains tax when the shares are sold.¹⁵ Interest paid on loans to fund investments are only deductible in limited circumstances, including where the loan is used to fund a company that the individual works for, or has a significant ownership stake in.¹⁶ Expenses relating to property investment can only be offset against other rental income. Unused rental losses can be carried forward and offset against future rental income. A recent budget measure, to be phased in from 2017, will limit the value of tax deductions for interest expenses relating to investment properties, allowing landlords to only deduct interest expenses up to the basic level of income taxation (20 per cent).

¹⁰ See for example, guidance by HM Revenue & Customs: www.hmrc.gov.uk/manuals/bimmanual/bim37010.htm.

¹¹ Inland Revenue Department of New Zealand 2014, *Returns Filed 2004 to 2013*, Inland Revenue, viewed 1 December 2014, www.ird.govt.nz/aboutir/external-stats/tax-returns/returns-filed/; The Treasury (New Zealand) 2012, *2012 Budget Key Facts for Taxpayers: Who pays income tax ... and how much?*, New Zealand Government, viewed 1 December 2014. www.treasury.govt.nz/budget/2012/taxpayers/02.htm/ both cited in Australian Government 2015, *Re:think Tax Discussion Paper*, page 54.

¹² Where working age is defined as ages 18 to 64.

¹³ Norway, Finland, Sweden and Denmark.

¹⁴ Australian Government 2015, *Re:think Tax Discussion Paper*, page 71.

¹⁵ UK Government, *Tax when you sell shares*, <https://www.gov.uk/tax-sell-shares/work-out-your-gain>.

¹⁶ UK Government, *Helpsheet 340*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/323775/hs340.pdf.

20. In the US, there is tax relief available for investment-related expenses, but generally only to the extent that the expenses exceed the ‘standard deduction’ available to the individual taxpayer and also exceed, in aggregate with certain other expenses, two per cent of income.¹⁷ Interest expenses on investments are usually deductible, but are limited to the amount of investment income generated; however any interest expenses over this amount can be carried forward to future years.¹⁸ Rental properties are generally considered ‘passive activities’ in the US, which restricts the ability to deduct losses. Losses from rental properties cannot generally be deducted unless the taxpayer has income from other passive activities; any excess loss can be carried forward. Where rental activity is considered non-passive income, a cap of US\$25,000 is placed on the amount of loss that can be deducted against other income.
21. Canada allows deductions for many investment-related expenses including brokerage fees, investment management costs and interest expenses that are used to generate income.¹⁹ Canada ostensibly allows negative gearing, but only for investors who expect to produce rental income independent of capital gains. That is, negative gearing is not permitted by individuals who invest primarily to generate capital gains.
22. So while Canada and the US may seem to allow negative gearing, various limits reduce its effectiveness as a tax minimisation tool. Table 4 below summarises the rules on interest deductibility and negative gearing in selected OECD countries.

Table 4: Interest deductibility and negative gearing in selected OECD countries

	<u>Interest deductibility</u>		<u>Tax on imputed rents</u> ²⁰	<u>Negative gearing</u>
	Own home	Investment home		
Australia	No	Yes	No	Yes
Canada	No	Yes	No	Limited
New Zealand	No	Yes	No	Yes
Switzerland	Yes	Yes	Yes	Limited
United Kingdom	No	Yes	No	No
United States	Yes	Yes	No	Generally not

Source: Ellis, L. 2006, “Housing and Housing Finance: The View from Australia and Beyond”, RBA Research Discussion Paper and Cheung, C. 2011, “Policies to Rebalance Housing Markets in New Zealand”, OECD Economics Department Working Papers, No. 878.

¹⁷ OECD, Taxing Wages 2013-14, http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/taxing-wages-2015_tax_wages-2015-en#page199,527-528.

¹⁸ OECD, Taxing Wages 2013-14, http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/taxing-wages-2015_tax_wages-2015-en#page199,527-528.

¹⁹ Canada Revenue Agency, Carrying charges and interest expenses, <http://www.cra-arc.gc.ca/tx/ndvdl/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns206-236/221/menu-eng.html>.

²⁰ Imputed rent is the value of housing services a homeowner receives from living their own home.

Other Considerations

Compliance burden

23. Personal tax deductions create a compliance burden for those who claim them, due in a large part to substantiation and record keeping requirements.²¹
24. For individuals to claim WRE deductions, they must have actually spent money, it must be related to their job and they generally need a record to prove it. Written evidence must be retained for five years to substantiate WRE claims over \$300. While the general principles underlying deductibility for WREs are simple, they are underpinned by various legal and administrative rulings and decisions. There are difficulties in correctly characterising and apportioning expenses between income-earning purposes and private purposes, and in defining and claiming deductions for WREs, creating uncertainty for taxpayers.²² 74 per cent of taxpayers used a tax agent to lodge their 2012-13 tax return²³, which is one of the highest rates of tax agent usage in the OECD.²⁴
25. The ATO continues to seek opportunities to use technology to reduce complexity and compliance costs.²⁵ In 2014, myTax was introduced, which offers a simple online interface through which most taxpayers with simple tax affairs can access and lodge tax returns pre-filled by the ATO. This is being rolled out to more taxpayers, and is expected to save approximately \$156 million in compliance costs each year.²⁶ In 2015, the myDeductions tool was introduced, allowing individuals to capture, classify and pre-fill deductions in their tax return.²⁷

Integrity

26. Deductions can provide tax planning opportunities for some individuals, which can undermine the integrity and sustainability of the tax system. This may occur if individuals structure their affairs to maximise the value of deductions. Alternatively, some individuals may attempt to push the boundaries by increasing the value of their deductions. The tax benefit of this can be limited by the requirement that expenses should generally be apportioned based on how much is for private use.²⁸ Deductions also provide a greater benefit for higher income earners, as they reduce the tax payable by marginal tax rates.
27. Changes to the rules for WRE deductions could also provide a greater incentive, where possible, for employees to re-characterise themselves as contractors, in order to access deductions currently claimed as WREs under a business structure. However, tax is only one factor that

²¹ Treasury 2015, *Stocktake and Audit of Regulation: Final Compliance Costs Report*.

²² Treasury 2011, *Making tax time simpler: Standard deduction for the cost of work-related expenses and the costs of managing tax affairs – Discussion paper*.

²³ ATO 2015, *Taxation Statistics 2012-13*.

²⁴ Treasury 2011, *Making tax time simpler: Standard deduction for the cost of work-related expenses and the costs of managing tax affairs – Discussion paper*.

²⁵ Australian Government 2015, *Re:think Tax Discussion Paper*, pages 177-178.

²⁶ Australian Government 2014, Spring Repeal Day October 2014, viewed 10 December 2014:

www.cuttingredtape.gov.au/sites/default/files/documents/2014_spring_repeal_day_overview.pdf, cited in Australian Government 2015, *Re:think Tax Discussion Paper*, page 178.

²⁷ ATO, 2015, myDeductions, viewed 18 December 2015: <https://www.ato.gov.au/General/Online-services/In-detail/Transact-Online/myDeductions/myDeductions/>.

²⁸ Australian Government 2015, *Re:think Tax Discussion Paper*, page 51.

impacts on the incentives to become a contractor — other considerations might include insurance requirements and the potential loss of leave entitlements and superannuation contributions.

Fringe benefits tax regime

28. Any changes to the arrangements for WRE deductions would need coordination with the fringe benefits tax (FBT) regime. Under the current FBT rules, the 'otherwise deductible rule' may apply to the benefits provided from employers to employees if the benefit would be deductible had it been purchased by the employee. In these cases, the taxable value may be reduced by the amount the employee would have been entitled to claim as an income tax deduction. Any changes to WRE deductions would have to consider behavioural responses, including the extent to which work-related benefits would be provided by employers, as well as any necessary flow-on changes to the FBT rules.
29. The Government is currently considering these issues as part of the Tax White Paper process.

Business Deductions

30. Businesses are also subject to income tax based on their taxable income. While income of sole traders, partnerships and, in the main, trusts, are taxed in the hands of their owners, companies are taxed at the corporate level, then this tax is 'imputed' to the owners of companies, that is shareholders via the franking system. So expenditure by business that has a relevant connection with business activities is deductible provided it is not capital, private or domestic in nature.
31. Expenses relating to the everyday operation of a business are known as revenue expenses and are deductible in the year in which they are incurred. Common revenue expenses include interest on loans for the business, advertising, insurance and utilities. Other expenses, such as those relating to the purchase of buildings and other assets, are deducted over a longer period of time. These are known as capital expenses and unlike revenue expenses, are not usually deductible in the year they are incurred. Rather, an amount of decline in asset value or depreciation can be claimed each year over a number of years.
32. The impact of business deductions on taxable income is shown in Table 5 below.

Table 5: Companies – business deductions, total and taxable revenue 2010–11 to 2012–13 income years

	2010-11		2011-12		2012-13	
	no.	\$b	no.	\$b	no.	\$b
Number of companies	870,505	n/a	879,120	n/a	854,745	n/a
Total Income	746,235	2,514	757,760	2,640	737,735	2,715
Interest expense within Australia	327,515	152	328,315	157	318,545	131
Interest expense overseas	10,855	32	11,205	32	4,490	33
Total expenses	782,845	2,271	793,170	2,410	772,175	2,486
Total profit or loss	778,710	242	788,455	230	767,260	229
Taxable profit or loss	658,265	217	672,000	234	659,950	216

Source: ATO 2015, *Taxation Statistics 2012-13*.

Importance of interest deductions

33. Interest is deductible for tax purposes to the extent it is incurred in gaining or producing assessable income or for the operation of a business. As with other business deductions, the expense cannot be capital, private or domestic in nature.
34. Permitting businesses to deduct the cost of interest on borrowings reduces the overall financial impact on business and allows resources to be used more efficiently.
35. Consider a business operating in an industry with high levels of expenditure, particularly early on in the business life cycle. The ability for the business to borrow funds and deduct the interest and other expenditure against assessable income significantly benefits the business, provides an incentive for investment and positively impacts the economy. Without the ability to deduct the cost of expenditure, some profitable investments may happen in other jurisdictions or not at all.

36. A model where interest expenses would not be deductible and interest and dividend income would not be assessable has been mooted in academic literature,²⁹ but no country has implemented such a model. Although this would remove the current distortion towards deductible debt financing (compared with non-deductible equity financing) this model would increase the cost of capital.³⁰ As Australia is a small, open, capital importing country in a world of greater global economic integration and highly mobile capital, any change to the tax deductibility of interest must be carefully considered.

Interest deductions in the international tax framework

37. The international taxation system has developed over many years and consists of the national tax systems of countries worldwide. As countries have the sovereign right to determine their applicable domestic corporate tax settings, including what income is taxed and how tax is assessed, the international tax system is a complex mix of varying rules.

38. Most countries have integrity rules that apply to interest arising from international transactions. In particular, Australia has comprehensive thin capitalisation rules and tough transfer pricing rules.

Thin capitalisation

39. The thin capitalisation rules aim to prevent excessive debt financing by disallowing interest expense if the underlying debt exceeds certain limits.³¹ The rules apply to Australian entities investing overseas and foreign entities investing directly into Australia, and limit interest deductions by limiting the amount of debt the entity can allocate to their Australian operations.

40. Of particular note, the arm's length debt test (one of three tests available to determine the allowable level of debt deductions³²), which benchmarks commercial or truly independent debt levels for the Australian operations, is a critical component of Australia's thin capitalisation rules.³³

41. The current thin capitalisation regime was introduced in 2001 and significant changes were made to prevent multinationals from claiming excessive debt deductions in 2014. Treasury is currently considering the impact of these changes, as well as the final OECD/G20 recommendations addressing Base Erosion and Profit Shifting (BEPS).

²⁹ First proposed by the United States Department of the Treasury in 1992.

³⁰ Australian Government 2006, *International Comparison of Australia's Taxes*; Australian Government 2008, *Australia's Future Tax System (Henry Tax Review) Architecture of Australia's tax and transfer system*.

³¹ Division 820 of the ITAA 97.

³² The two alternative tests are the 'safe harbour test' (a set rate of debt that an entity can use to fund its Australian operations) and the 'worldwide gearing ratio test' (allows gearing of the Australian operations to be geared up to the level of the worldwide group).

³³ Board of Taxation 2014, *Review of the Thin Capitalisation Arm's Length Debt Test*.

Transfer pricing

42. The transfer pricing rules³⁴ broadly operate so as to require related parties that enter into a cross-border transaction to price that transaction as if they were unrelated parties operating on an arm's length basis. These rules may impact on related party interest deductions, as the interest charged on borrowings must be priced according to the arm's length interest rate of the loan.
43. Australia recently strengthened its transfer pricing rules to more closely align with international best practice, as represented by the *OECD Transfer Pricing Guidelines*. Treasury expects to conduct targeted consultation in early 2016 in relation to adopting the final OECD/G20 BEPS transfer pricing recommendations into Australia's domestic rules. These recommendations, if adopted, may provide the ATO with enhanced guidance for determining whether a transaction has been priced on an arm's length basis.

³⁴ Division 815 of the ITAA 97.