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Committee Secretary
Standing Committee on Economics
PO Box 6021
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By email: economics.reps@aph.gov.au

Dear Sir or Madam

INQUIRY INTO TAX DEDUCTIBILITY

Thank you for the opportunity to comment on the Standing Committee on Economics' Inquiry into Tax Deductibility.

The Australian Chamber of Commerce and Industry (the Australian Chamber) is Australia's largest and most representative business association, comprising state and territory chambers of commerce and national industry associations and representing more than 300,000 businesses of all sizes, across all industries and all parts of the country.

General comments

The terms of reference ask the Committee consider options for simplifying and broadening the personal and corporate income tax bases with the goal of lowering the overall rate.

Base broadening and simplification can be useful strategies for raising revenue more efficiently. However, broadening the personal and corporate income tax base does not address the fact that Australia is much more reliant than other countries on income tax, particularly corporate income tax. In contrast, Australia raises a very small proportion of its revenue from consumption taxes like the GST. This over-reliance on inefficient income taxes is a core problem for the Australian tax system that any comprehensive tax reform package must address.

Recommendation 1: Need for broader tax reform

Base broadening should not be a substitute for a fundamental shift from income taxes to consumption taxes.

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The terms of reference give the Committee scope to consider a wide range of issues from superannuation, through to capital gains tax, fringe benefit tax, the Medicare levy and the Low Income Tax Offset. However, these issues have been discussed extensively in the Tax White Paper process. As such we encourage the Committee to focus more narrowly, the title of the Inquiry implies, on tax deductibility.

Work related expenses

The terms of reference explicitly refers to deductions for work related expenses (WRE). Deducting work related costs from taxable income recognises that some people have less to spend on consumption because they incurred costs in earning their income, including cars, travel, uniforms and self-education. The theory here is relatively uncontroversial, but in practice it is hard to make sure that only legitimate deductions are claimed. As such, there are restrictions around what can be claimed and integrity measures create complexity and compliance costs.

As a general rule, Australia allows workers to deduct a wider range of expenses than other countries. In Australia (with some exceptions) employees can claim expenses incurred in gaining or producing assessable income whereas UK only allows expenses incurred wholly, exclusively and necessarily in the performance of an employee's duties.

The Henry Review recommended granting everyone a standard deduction, as well as introducing a "tighter nexus between the deductibility of the expense and its role in producing income" for expenses above the threshold, suggesting that the new test could be similar to the UK approach.

A standard deduction would provide simplification, but a standard deduction without other changes would come at a high cost to revenue as everyone below the threshold would claim it, while everyone with expenses above the standard deduction would continue to claim.

Pairing a standard deduction with a tighter nexus between expenses and work could offset the costs of a standard deduction and may still provide a significant net positive to revenue that could be used to lower overall tax rates. However, many of the expenses ruled out under a tighter nexus could be legitimate. For example, ruling out self-education expenses may lead to a substantial underinvestment in human capital.

There is also a risk that employers will be forced to fill the funding gap left by the removal of deductions. This may be problematic as often the reason employers choose not to fund certain expenses is that the goods or services purchased can be carried on to other employers if the employee moves jobs. This may be particularly problematic for small businesses that have less negotiating power with their employees and where there are likely to be fewer internal promotion opportunities.

Any substantial change to deductions for WRE would be premature without much stronger evidence to suggest that a significant proportion of WRE deductions are being inappropriately claimed. If any change were to be made, careful consideration would also need to be given to whether to apply a blanket test along the lines of the UK approach, or make special provisions for certain types of expenses.

Recommendation 2: WRE Deductions

Tightening access to deductions for WRE seems worthy of further investigation, but any change would be premature without much stronger evidence to demonstrate that existing deductions are being inappropriately claimed.

Negative gearing

There has been considerable public pressure to change arrangements for 'negative gearing' as it relates to rental properties and as a supposed measure to address housing affordability. A rental property is negatively geared if it is purchased with the assistance of borrowed funds and the rental income, after deducting expenses, is less than the interest of the borrowings. The broader definition of negative gearing doesn't only apply to residential property but to a range of asset classes, yet residential property is often singled out in public discussion, with the benefits of greater rental market supply and increased savings of middle Australia largely overlooked.

Current negative gearing provisions for residential property are an important feature required to underpin private investment in housing. The existing tax arrangements have seen the private sector become a much larger provider of rental housing and greater private sector involvement has enabled the state and commonwealth governments to operate more cost efficient models of housing support (e.g. rent assistance for low income households rather than provision of housing).

Removal of negative gearing would have an adverse impact on housing affordability evident, for example, adding to rental inflation. Investors require a return on their investment and the return is considered on an after tax basis. A higher tax burden would require a higher pre-tax return. In a situation where there is a relatively tight rental market, as is the case in most capital cities, there is a substantial risk that investors would simply offset the increased tax burden with higher rents.

It is difficult to quantify the extent any changes would have on rental supply. In situations where investors are unable to recover or carry the cost of additional taxation they are likely to be forced to exit the market. ATO statistics show that those claiming deductions for property investment typically have a taxable income below

$80,000 per year and own only one investment property, therefore any such changes would largely affect these mid-income households. It is a misnomer that negative gearing is only used by the wealthy. Being less capital constrained, wealthier investors are more likely to be positively geared and therefore less likely to be forced out of the market as a result of any changes to negative gearing.

Negative gearing for rental property is not different in substance to borrowing for other income producing assets such as shares where expenses, including interest, are deductible and should not be treated differently. Rather than penalising future investment in residential property through higher taxation we should be looking as a nation to address the structural circumstances which have pushed property prices higher. An examination of the proliferation of supply side constraints related to excessive taxation and regulation (e.g. planning restrictions) are obvious places to start. Criticism of negative gearing is often based on the misguided presumption that negative gearing is the exploitation of a loophole, but that is incorrect. On a pure tax basis, rental income is assessable and it is entirely appropriate that rental outgoings are deductable. There is no justification for undermining the idea of borrowing to invest because the interest payments are deductible.

The fact that negative gearing supports property investment is actually quite positive for businesses – especially small businesses. Many small businesses leverage property to either start or expand a business and a healthy property sector is critical to a healthy small business sector. Any issues relating to the affordability of housing for first home buyers are typically more geographic in nature and Australia's tax system should not be used as a blunt instrument to restrain property market prices in any particular geography.

The Henry Tax Review specifically acknowledged that changing taxation arrangements such as negative gearing on residential property were not a panacea for addressing Australia's housing affordability problems.

Improving housing affordability will best be achieved by actioning structural impediments to improved housing supply (for example, better land release and planning policies).

Recommendation 3: Negative gearing

Individuals should continue to be able to deduct interest expenses incurred in producing income from their assessable income.

Corporate interest expenses

On corporate income tax, the main issue mentioned in the terms of reference is the deduction for interest expenses. It is widely accepted that the fact that interest is deductable from the corporate income for tax purposes, but dividends are not, creates an incentive to finance investment with debt rather than equity capital.

The distortion is most significant for firms that raise funds on international capital markets, as domestic firms have more favourable treatment of equity investment as a result of the dividend imputation system.

Thin capitalisation rules exist in part to address the debt/equity distortion as well as to deal with more general tax planning issues.

The Business Tax Working Group considered and rejected proposals to broaden the corporate tax rate and lower the rate by tightening thin capitalisation rules or capping interest deductions for all business taxpayers.

It seems particularly counterintuitive to limit corporate access to debt now, at a time when capital costs are at historic lows and low levels of a business investment are a key drag on growth.

A more radical solution to the debt/equity distortion involves completely eliminating the interest deduction and moving to what is called a Comprehensive Business Income Tax (CBIT). The benefit of this approach is that it allows the headline corporate tax rate to be much lower.

A CBIT would encourage more mobile and profitable firms to locate in Australia (because of the lower headline rate), but it would also discourage inward investment of debt capital and create major transitional costs.

Moving to a CBIT would be a fundamental change to Australia's tax system and would have to be considered alongside other options for fundamentally changing the structure of the corporate tax system. Even then there would need to be strong evidence showing that the benefits would outweigh the costs as such a major change in the way capital income is taxed could create significant uncertainty for business and affect the viability of many existing investments.

Recommendation 4: Interest deductibility for corporate income tax

Tightening thin capitalisation rules or capping interest deductions is a very arbitrary way of addressing the debt-equity bias. No clear arguments have been advanced on why changes are needed, and any amendments are likely to create uncertainty and transitional costs that may reduce investment.

More fundamental changes to interest deductibility, such as moving to a comprehensive business income tax, need to be considered alongside alternative changes to the structure of the corporate tax system, and would require strong evidence that the benefits would outweigh the likelihood of major transitional costs

Thank you in advance for your consideration of the issues raised in this letter.
If you have any questions or would like to discuss our suggestions further, please contact Tim Hicks, Senior Manager of Economics and Industry Policy, on 02 6270 8042 or at tim.hicks@acci.asn.au.

Yours sincerely

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