



Law Council
OF AUSTRALIA

Business Law Section

Committee Secretary
House of Representatives Standing Committee on Economics
PO Box 6021
Parliament House
Canberra ACT 2600
Via email: economics.reps@aph.gov.au

15 January 2016

Dear Sir or Madam,

Inquiry into Tax Deductibility

The Taxation Committee of the Business Law Section of the Law Council of Australia (the **Committee**) welcomes the opportunity to make submissions to the House of Representatives Standing Committee on Economics (the **Standing Committee**) regarding the Inquiry into Tax Deductibility (the **Inquiry**).

This submission responds to the Inquiry's Terms of Reference released by the Standing Committee. The Committee has set out its submissions below.

Outline of Submission

The Committee refers to the Inquiry Terms of Reference as follows:

The Committee will examine some options to simplify the personal and company income tax system, with a particular focus on options to broaden the base of these taxes in order to fund reductions in marginal rates. Matters to be examined include:

- The personal tax system as it applies to individual non-business income, with particular reference to the deductibility of expenditure of individuals in earning assessable income, including but not limited to an examination of comparable jurisdictions such as the United Kingdom and New Zealand; and

- The company income tax system, with particular reference to the deductibility of interest incurred by businesses in deriving their business income.

The Committee submits that any steps taken to simplify the personal and company income tax systems should take the following factors into account:

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- that any change to the personal tax system should not involve caps being applied to deductions for self-education expenditure;
- that any changes to the personal tax system should not involve changes to the use of negative gearing losses to offset income;
- that the deductibility of interest incurred by businesses in deriving their business income is an essential component of a neutral tax system, and that the abolition of interest deductions would result in a reduction in investment, job creation and economic growth; and
- that Australia already has sufficient rules¹ to prevent base erosion through the use of interest expenses.

Part 1 – Deductibility of expenditure in the personal tax system

Personal Tax System - Deductibility in New Zealand, United Kingdom and Australia

The Committee makes the following general comments regarding deductibility of expenditure in the personal tax system.

The personal tax systems in Australia, the United Kingdom, Canada and the United States all allow employee deductions for expenses relating to the derivation of income.

This can be contrasted with the personal tax system of New Zealand, which since 1988 has prohibited employment related deductions. The relevant clause in the current legislation² is as follows:

DA2 General limitations

Employment limitation

*(4) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving income from employment. This rule is called the **employment limitation**.*

The reasoning behind the New Zealand decision to abolish employment related deductions was said to include an increase in certainty in the tax system, the prevention of taxation abuse opportunities and the simplification of returns for both the taxpayer and revenue authority. It was also said to be a way of recognising the employer's responsibility to reimburse employee expenditure.

We note however that the Australian personal tax system is already implementing changes to increase certainty and to prevent opportunities for abuse, and that relying upon an employer to reimburse employee expenditure is based on the assumption that all

¹ Including the Thin Capitalisation Regime and the Transfer Pricing rules

² *Income Tax Act 2007* (NZ)

employers will be in a position to, and elect to, reimburse their employees. This would appear to be a system which would be arbitrarily unfair to some employees.

It also should be noted that the highest personal income tax rate in New Zealand has (in the 25 years since the abolition of personal income tax deductions) gone from 66% to 33%, as compared to the current Australian top marginal rate of 47% (plus Medicare levy).

It is the Committee's submission that the ability to deduct expenditure relating to the derivation of employment income is in keeping with similar jurisdictions (save for New Zealand, which had a corresponding significant decrease in marginal tax rates), and is not in need of significant change.

We note that it separately creates a distinction between the tax treatment of an individual engaging in trade as an employee and one engaging in trade as a sole trader. Without addressing this distinction, it creates a regime which might lead individuals to seek to structure their business affairs in a manner which they might otherwise not.

Personal Tax System – Self-Education Expenditure

The Committee refers the Standing Committee to the joint submission made by the Committee and the Tax Institute to Treasury dated 16 July 2013 (copy attached).

It is the Committee's submission that any changes to the personal tax system should not include the imposition of a cap on self-education expenditure, as was canvassed by Government in 2013³.

The Committee reiterates its concerns set out in the joint submission regarding this issue, which we summarise as follows:

- the implementation of a 'cap' is a blunt instrument which targets all individuals who incur self-education expenses rather than just the individuals who claim the type of expenses which may be of concern to the government;
- a cap does not take into account the fact that some employees are required to incur their own education expenses, as their employer is unable or unwilling (for reasons of their own) to support their employees in maintaining and extending their professional skills and qualifications for the purpose of their employment; and
- a cap would also result in discouraging expenditure by individuals on improving their existing skill base. Though perhaps unintended, the suppression of skilling up, if not deskilling, of the workforce and businesses will occur.

Personal Tax System - Negative Gearing

The Committee makes the following general comments regarding the personal tax system and negative gearing.

The concept of 'negative gearing' requires the deductibility of interest expenditure.

³ See Deputy Prime Minister and Treasurer Media Release No. 48 dated 13 April 2013

Interest is ordinarily deductible in Australia as long as it has the necessary nexus with the assessable income; section 8-1 of the *Income Tax Assessment Act 1997 (ITAA97)*. That is, the interest must be incurred in "gaining or producing" assessable income.

Negative gearing results when there is a disproportion between the outgoings and the assessable income. Generally negative gearing is allowed in Australia with no restriction on the use of the losses created by a negatively geared asset against income from other assets or, more commonly, employment income.

The unrestricted use of negative gearing losses to offset income from other sources available in Australia is in keeping with the tax law in New Zealand, and to a limited extent, the United Kingdom (where losses from an asset are quarantined to profits from assets in the same income year).

Negative gearing was abolished (for real estate investors only) in Australia for a period of less than two years beginning on 17 July 1985⁴. When deciding whether to reinstate negative gearing, there was argument around whether the lack of negative gearing had led to various undesirable consequences such as a decrease in construction of new residential property, a decrease in investor purchases and higher property rentals.

It is the Committee's submission that no changes should be made to the current rules around negative gearing given that the rules are comparable to similar jurisdictions and a change in the rules may have undesirable economic consequences.

Part 2 – Company Income Tax System

Interest Deductibility

The Committee makes the following general comments regarding interest deductibility in the company income tax system.

Australia can be distinguished from countries such as New Zealand, Canada and the United Kingdom in that it is the only jurisdiction in this group which does not have specific legislative provisions dealing with the deductibility of interest.

That is, Australia relies upon the general provisions on deductibility in section 8-1 of the *Income Tax Assessment Act (1997)* rather than a specific 'interest deductibility' section.

That said, with the exception of the United Kingdom (which uses an allocation method), all of these countries including Australia ultimately use a tracing test to determine whether the relevant interest expense was incurred in gaining or producing assessable income or in carrying on a business.

The Committee, whilst acknowledging that there are arguments and economic justifications for treating debt the same as equity, submits that the deductibility of interest in the company income tax system is in keeping with similar jurisdictions. Reform of interest deductibility would carry significant risks such as costly restructuring for companies.

⁴ We refer to the 1985 Hawke/Keating government quarantining of negative gearing interest expenses

Further, Australia has adequate rules to prevent base erosion through the use of interest expense, including the Thin Capitalisation Regime and the Transfer Pricing rules.

Should the Standing Committee wish to discuss these views with the Committee, discussions can be initiated by contacting the Committee Chair, Adrian Varrasso on (03) 8608 2483 or via email: adrian.varrasso@minterellison.com

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Teresa Dyson', written in a cursive style.

Teresa Dyson, Chairman
Business Law Section

enc.



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Law Council
OF AUSTRALIA

Business Law Section

16 July 2013

Mr Paul Tilley
Manager
Individuals Tax Unit
Personal and Retirement Income Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: selfeducationtaxreform@treasury.gov.au

Dear Mr Tilley,

Reform to deductions for education expenses – Discussion Paper

The Tax Institute and the Business Law Section of the Law Council of Australia (**Joint Bodies**) are pleased to have the opportunity to make a submission to the Treasury in relation to the *Reform to deductions for education expenses* Discussion Paper (**Discussion Paper**) that proposes to impose a \$2,000 cap on deductions for losses and outgoings incurred in relation to education.

The Joint Bodies note that there has been an overwhelming negative public response to this proposed measure since the Government announced the measure on 13 April 2013¹. This response has come not only from tax professionals who advise on the operation of the tax law, but from taxpayers directly affected by the announcement, numerous professional bodies, many members of the different professions who have education requirements to meet and from the educators who provide this necessary education to maintain high standards among Australian professionals. This response should be regarded by Government as a reflection of the profoundly flawed nature of the proposal and its inconsistency with other recent policy changes.

Executive Summary

- The Joint Bodies are deeply concerned with the use of a blunt and pervasive instrument to address some very specific concerns the Government has with some aspects of entitlement to a deduction for losses and outgoings incurred in relation to education. Among other problems with the proposal, it is a

¹ See Deputy Prime Minister and Treasurer Media Release No. 48 dated 13 April 2013 (**Media Release**)

disproportionate response to perceived excessive expenditure by a minority of taxpayers.

- The proposed measure is highly unlikely to achieve the Government's outcomes of better targeting the deduction and preventing perceived large claims. All claimants will instead be penalised.
- Sole traders are at particular risk of unfair treatment with the imposition of a cap on self-education expenses that are necessarily incurred in the course of carrying on their businesses.
- A suitable alternative may be to tighten administration around the existing deduction available including imposing reasonable limits on particular categories of losses and outgoings and, if warranted, perhaps consideration of a carefully designed, targeted legislative response to the perceived excesses.

Discussion

Our submission addresses the following matters:

- lessons from the Henry Review;
- inconsistency with recent policy changes;
- amount of expenditure should not drive reform of the deduction;
- why the measure is unlikely to achieve the Government's outcomes;
- an alternative approach to more effectively address the Government's concerns; and
- our concerns addressing specific aspects of the Discussion Paper.

1. Lessons from the Henry Review.

The Henry Review² considered work-related expense deductions including, self-education expenses. The principle against which these expenses were examined included that:

Earned income subject to taxation should be net of the costs directly incurred in earning that income. Work-related expenses should be clearly defined as those that are necessary to produce income³.

Together with recommending a standard deduction (which the current Government is no longer going to introduce) was the recommendation that there should be a tighter nexus between the deductibility of the expense and its role in producing income⁴.

With particular reference to self-education expenses, the report said:

Education and training is an essential part of human capital development and a significant contributor to economic outcomes for all Australia. It is essential that

² *Australia's Future Tax System, Tax Review (Henry Review)*, report to the Treasurer,

³ See p53 of Part 2 Vol 1 Henry Review

⁴ Recommendation 12 Henry Review

Australians have opportunities to train and study, both to enhance their skills for their current employment and to pursue new opportunities...

Following this, it was noted that tax deductions had an incentivising role to encourage further education and training⁵. The report concluded that tuition fees for education related to current employment should be fully deductible. Further, the report concluded that other associated expenses, such as travel and educational materials, should be included in the [now moot] standard deduction.

The report also observed that allowing deductions for work-related expenses is intended to improve the equity of tax treatment between taxpayers who incur costs in producing their income and those who do not. It was also observed that most work-related expenses, including for education, generally increase with income. Factors contributing to the variation in work-related expense claims, including those for education expenses, include:

- differences in taxpayers interpreting how expenses could be claimed;
- differences in employer behaviour (some employers are willing to pay for certain expenses and others are not);
- taxpayers over-claiming (for expenses that may be private in nature – in line with the Government's concern here).

The guiding principles that can be drawn from this valuable review of Australia's taxation system are that:

- deductions for losses and outgoings incurred in relation to education should not be capped; and
- some form of limitation on associated expenses (such as travel and accommodation) may be appropriate.

All the variables contributing to the variation in work-related expense claims noted above should be taken into account in any review and recasting of education expense deductions, not just one aspect of them.

What should govern the overall determination of the structure of the deduction for education expenses is the necessity to encourage investment in education to improve human capital resources and contribute to the overall betterment of the Australian economy. There is a significant role the tax system can and should play in supporting this. The tax system has a role in influencing behaviour. The disincentive provided by the proposed measure may result in workforce de-skilling.

⁵ See p59 of Part 2 Vol 1 Henry Review

2. Inconsistency with recent policy changes

Currently, taxpayers may claim expenses for self-education where the nexus test underlying section 8-1 of the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**) is met.

As with most other deductions within the purview of section 8-1, substantiation rules have a policy and integrity role to play. Substantiation rules are but one category of available policy and integrity measures that can apply to deductions under the Australian taxation system. In order of increasing severity, others include reasonable limits to and caps on deduction entitlements.

The proposed measure will subject education expenses to a cap, moving well away from allowing a deduction in full subject to appropriate substantiation, and bypassing the intermediate integrity/policy measure of reasonable limits. We note the recent policy change concerning the FBT exempt accommodation component of the Living-away-from-home (**LAFH**) allowance. There the Government has moved away from imposing a reasonable limit to requiring substantiation⁶. The policy change underpinning the proposed capping of education expense deductions, which proposes to move away from substantiation to a cap, is inconsistent with the recent LAFH policy change.

Though the Joint Bodies disagree with the proposal in its entirety, should the Government be of the view a policy change is required for the treatment of education expenses, we suggest (per our comments below) that perhaps a more measured response, such as a move towards imposing reasonable limits on certain expenditure⁷ associated with education, instead be considered.

3. Amount of expenditure should not drive reform of the deduction

In the Media Release, the then Treasurer noted that the absence of a cap on deductions under the current arrangements provided an “opportunity” for people to enjoy “significant private benefits”. Those private benefits alluded to purportedly include first class airfares, five star accommodation and expensive courses.

The nexus test underlying section 8-1 of the 1997 Act is the appropriate test for determining whether a loss or outgoing was incurred in gaining or producing assessable income or in carrying on a business to derive assessable income and consequently the amount of that loss or outgoing that may be deductible. This test is consistent with long held, and recently endorsed, principles that it is not for the Commissioner to tell a taxpayer what is to be incurred in gaining or producing

⁶ Refer to the amendments made to the *Fringe Benefits Tax Assessment Act 1986* (Cth) by the *Tax Laws Amendment (2012 Measures No. 4) Act 2012* (Cth)

⁷ For example travel and accommodation expenses

assessable income or in carrying on a business to derive it, rather the task is to determine whether the loss or outgoing in question was so incurred⁸.

Higher and better education should be encouraged without regard to the size of the cost incurred. In this regard, the size of the expense of a particular form of education should not factor into reform of the current deduction. As an example, the cost of each subject in many post-graduate university courses alone exceeds the proposed cap amount. Another example is the cost of a daily or periodical current service. One such subscription might absorb most, if not all, of the \$2,000 cap resulting in all other continuing professional education expenditure being non-deductible.

Given Australia is no longer competitive as a manufacturing economy in many sectors, maintaining currency of, and adding to, Australia's intellectual capital base is a necessary endeavour to protect the future of Australia. Further education of Australians is necessary to achieving this. To compromise this endeavour by adding to the cost of education by capping the availability of the deduction is counterproductive. The cost of education courses that meet the requirements of the nexus test should not only be fully deductible, but participation in these endeavours should also be encouraged.

4. The measure is unlikely to achieve Government's outcomes

In the Media Release, the then Treasurer also stated that the Government will "better target work related self-education expense deductions". The stated purpose of introducing a cap on the deduction is to "ensure the system remains fair".

The Joint Bodies question how the sought after fairness is achieved by imposing a cap that would affect all taxpayers notwithstanding that only a small minority of taxpayers incur the losses and outgoings that are perceived to be problematic. Though it would address the minority of problematic claims, the blunt and pervasive instrument proposed would also affect deductibility of legitimate claims. A cap might well prevent large deductions from being claimed, but in doing so, it would also penalise Australians who, whether voluntarily or as required to maintain professional licences or membership, are endeavouring to maintain their qualifications for work or business who are not incurring unnecessarily excessive costs.

Most, if not all professionals, are required to maintain their knowledge and qualifications annually to ensure they keep up to date with the latest innovations in their area of expertise (for example in medicine), or simply to meet the requirements of their profession, including their licence to practice (for example accountants, tax agents⁹ and

⁸ *Tweddle v Federal Commissioner of Taxation* (1942) 180 CLR 1 at 7; *Ronpibon Tin NL & Anor v Federal Commissioner of Taxation* (1949) 78 CLR 47 at P 60; *Commissioner of Taxation v BHP Billiton Finance Limited* [2010] FCAFC 25 at [18]

⁹ Tax agents are required to undertake 90 hours of continuing professional education over a three year period to meet Tax Practitioners Board requirements.

lawyers¹⁰). Professionals may have to travel across Australia to attend conferences for the purpose of meeting certain continuing professional development requirements. Practitioners in rural areas of Australia will in the majority of cases have to travel to their nearest major city in order to obtain the education required in their profession. In some cases, attendance at venues outside of Australia will be essential in order to share in the knowledge that has developed offshore and to “import” those critical skills to Australia. This will particularly be the case in the medical and scientific fields where, of course, it is essential to keep up to date with international developments. In other cases, suitable training is only available overseas and is not on offer in Australia¹¹.

Acquiring further education is not only the domain of members of the traditional professions. Tradespeople also need to maintain their trade skills and keep up with advances in their trade to continue to be able to earn a living. For example, a motor mechanic needs to be educated on the new computer technology built into new cars; a fitter-and-turner needs to learn how to operate the latest generation of machine tools.

The cap does not take into account the fact that some employees are required to incur their own education expenses where employers are unable or unwilling (for reasons of their own) to support their employees in maintaining and extending their professional skills and qualifications for the purpose of their employment. Neither better targeting of the deduction nor fairness is achieved by disregarding employees in this position.

The cap will also result in discouraging expenditure by individuals on improving their existing skill base. Though perhaps unintended, suppression of up-skilling, or, worse, deskilling, of the workforce and businesses will occur. This is clearly the opposite to the Government’s position of valuing “the investments people make in their own skills”¹² and recognition of the benefit of allowing a tax deduction for self-education expenditure. This result is evidence the imposition of a cap will not achieve better targeting of the deduction that the Government seeks to achieve with this measure and is not an appropriate policy response to the specific perceived problems with the current deduction. A broad brush measure affecting all taxpayers without discrimination is not better targeting of work related self-education expense deductions. It is questionable whether it is any form of targeting at all.

5. Alternative Approach to addressing Government’s concerns

Addressing the Government’s perceived concerns consistently with pursuit of Government’s expressed policy of valuing “the investments people make in their own skills”¹³, calls for a more calibrated response. An alternative to the proposed measure would be for the Australian Taxation Office (**ATO**) to more fully utilise its existing

¹⁰ Requirements for legal practitioners with current practising certificates vary per State. For example, NSW requires 10 hours of continuing legal education annually.

¹¹ For example, a freelance commercial pilot is required to meet certain pre-requisite training obligations to maintain a licence under the Australian Aviation rules and often that training is only available overseas.

¹² See Media Release

¹³ See Media Release

powers in reviewing taxpayers' returns who claim self-education expenses. The ATO sets out the parameters for the administration of this deduction in *Taxation Ruling TR 98/9 (TR 98/9)*. Many examples are given showing which types of expenses can be claimed, those that must be apportioned and those that cannot be claimed¹⁴.

Tighter administration of the existing deduction is much more likely to achieve the Government's objective of targeting perceived large claims and so-called private benefits purportedly facilitated by the existence of this deduction. This would allow there to be a more calibrated response to certain claims made. Excessive or unreasonable claims could be clamped down on and necessary education costs incurred that may be large in size but otherwise justifiable would still be allowed. This would provide an equitable outcome between individuals whose minimum annual expenditure on self-education expenses will always be high and the few individuals who may well be taking inappropriate advantage of the self-education deduction to obtain a private benefit.

If the ATO were to revisit its administration of this expense, the Joint Bodies would be more than happy to consult with the ATO on this matter, including exploring the option of imposing a "reasonable expenditure" requirement.

In conjunction with this, the Government may wish to consider a very specific legislative amendment that targets those expenses that are considered, in the Government's view, to be large claims, that does not adversely impact on legitimate large claims. One approach may be to link acceptable claims to a guideline similar in nature to the public service guidelines¹⁵. This test of reasonableness is used as the basis for the guidelines already used by the ATO for determining reasonable travel and meal allowances as described in *Taxation Determination TD 2012/17*.

To achieve an effective legislative solution to the concerns expressed in the Media Release, any amendment would need to be carefully designed. The Joint Bodies would be pleased to assist the Government and Treasury to design an appropriate legislative amendment to ensure that it is appropriately targeted should the Government consider this as an appropriate alternative to the current proposed measure.

¹⁴For example, see paragraphs 67 to 70 of TR 98/9

¹⁵It may be appropriate to adopt a guideline broadly similar in nature to the public service guidelines though not necessarily appropriate to adopt certain specific elements, such as the dollar figures used in the public service guidelines. The range of circumstances in which this rule will need to apply is broad and many permutations will need to be taken into account when trying to devise an appropriate solution, such as the ability to work productively while travelling.

6. Specific aspects of the Discussion Paper

Attached in Appendix A are the Joint Bodies' detailed comments on specific aspects of the Discussion Paper.

If you would like to discuss any of the above, please contact either us or Tax Counsel, Stephanie Caredes, on 02 8223 0011 for The Tax Institute and Mark Friezer on 02 9353 4227 for the Business Law Section of the Law Council of Australia.

Yours sincerely



Steve Westaway
President
The Tax Institute



Frank O'Loughlin
Chairman
Business Law Section
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Appendix A – Specific aspects of the Discussion Paper

1. The appropriateness of the \$2,000 cap amount

The Joint Bodies dispute the appropriateness of the \$2,000 amount of the cap proposed and the all-embracing types of expenses included in it.

Self-education deduction information capture and the \$2,000 amount

Currently, a distinction is drawn between expenses characterised as for “formal education” and “informal education” as noted in the Discussion Paper. All of these expenses are deductible pursuant to section 8-1 of the 1997 Act. Overlaid onto this is the limitation imposed on the deduction for formal education under section 82A of the *Income Tax Assessment Act 1936* (Cth) (**1936 Act**) (discussed later). Paragraph 48 of the Discussion Paper lists the expenses to be included under the proposed cap, which includes expenditure on both formal and informal education.

For the purpose of declaring this expenditure in an individual’s tax return, currently this expenditure is broken down into items claimed at Item D4, being tuition (ie formal education fees), textbooks, stationery, student union fees, student services and amenities fees and decline in value of a computer used for education purposes. These are regarded as “work-related self-education expenses”. Other education-type expenses claimed at Item D5 include professional seminar and conference fees, union fees and subscriptions to trade, business or professional associations, reference books, technical journals, tools and equipment and professional libraries. These are termed “other work-related expenses”.

According to *Taxation Statistics 2010-11* published by the ATO in April 2013, the average claim for self-education expenses was approximately \$1,800¹⁶. It is not clear whether this includes claims made at both Items D4 and D5, however this is unlikely since details of claims made at Item D5 are generally not provided to the ATO¹⁷.

Treasury refers to the same 2010-11 statistical information in determining the median claim for education expenses of \$905¹⁸. Treasury notes that expenses claimed at Item D5 are not itemised¹⁹. However, an amount of \$296 is noted as the median claim for education-related expenses made at Item D5 for the 2009-10 income year based on unpublished data²⁰. The proposed cap seeks to incorporate various of the education-related expenses claimed at both Items D4 and D5. Though amounts can be estimated as representative of average or median claims for education expenses made at Items

¹⁶ This is based on approximately \$1,166,000,000 worth of expenses claimed by 638,153 individuals who made claims for self-education expenses in 2010-11.

¹⁷ Though records must be maintained to substantiate these claims.

¹⁸ Pp 5 and 6 of the Discussion Paper

¹⁹ Refer to Footnote 9 on p5 of the Discussion Paper

²⁰ Refer to paragraph 30 of the Discussion Paper

D4 and D5 based on published and unpublished data, these amounts do not necessarily justify imposition of a cap on the deduction of education expenditure.

We also note the reference to the median claim for self-education expenses of \$905 for individuals with incomes of less than \$80,000 representing 87% of individuals who made claims for self-education²¹. The Joint Bodies query the purpose of drawing this distinction as this sort of information is not particularly helpful. It is not the case that expenditure on self-education can be normalised across income bands and it can be expected that those earning higher incomes might incur higher self-education costs.

The Henry Review observed that most work-related expenses, including self-education expenses, increase with income²². This observation may reflect, for example, the increased capacity of someone on a higher income to incur the expenditure. It may reflect the fact that someone on a higher income may be a skilled worker with higher education requirements to meet and maintain as compared to a low-income unskilled wage earner. Indeed, the statistical information noted above supports these mere observations. However, it does not, and should not, lead to questioning of the validity or veracity of claims made by individuals on higher incomes, nor be a justification to deny their claims because they exceed a certain threshold amount.

Given all the variable factors involved in self-education claims and the marked differences in the amount and type of education required per the different professions, a much more rigorous analysis of the type and extent of claims for self-education expenses should occur before an “appropriate cap” can be determined.

This analysis could include looking at information such as:

- which profession/industry a claimant belongs to;
- whether the claim is for education required to maintain and develop within a field or whether it is undertaken to enter a new field or profession;
- the reasonableness of the expenditure (is it for economy or first class travel to attend the seminar?);

as well as the extent of claims made according to certain income brackets. Should the Government persist with imposing a cap on self-education expenses, it should reflect these many variables.

Expenses to fall under a cap

Following this review process, if the Government determines that a cap should be imposed on education expenses incurred by employees, then we recommend the following:

- Expenses that should be excluded from a cap include:

²¹ Refer to paragraph 28 of the Discussion Paper

²² See p54 of Part 2 Vol 1 of Henry Review

- tuition fees;
- registration fees for conferences, workshops or seminars and similar;
- textbooks and professional or trade journals²³;
- professional association membership fees.

Particularly in the case of professionals who are required to maintain their education to meet certain continuing education requirements of their profession, these types of expenditure have a sufficiently close nexus to the derivation of income.

- Expenses that could be subjected to reasonable limits:
 - travel, accommodation and meals associated with attending a conference, workshop, seminar or similar if required to be away from home for one or more nights;
 - stationery and photocopying incurred for a course of study;
 - student union fees and student services and amenities fees;
 - depreciation of a computer used for a course of study.

As these types of expenses are not direct expenditure on education, they therefore have a lesser connection with a person's ability to derive income. Accordingly, they could be subjected to reasonable limits. However, this would not cure the unintended effect of a cap in disadvantaging skilled professionals who desire to provide up to date services in regional Australia. A cap alone would not achieve equitable outcomes; for example a cap does not take into account additional travel expenditure regional practitioners would necessarily have to incur. Accordingly, a 'reasonableness' test (as suggested above) is a superior solution in this case.

We support the exclusion of the expenses noted in paragraph 51 of the Discussion Paper. We refer in particular to professional association membership fees. Certain professional membership fees may be attributable to the provision of education courses or seminars by the professional association. Where a certain part of the fee paid is attributable to the provision of education, on the basis that we are of the view that course and seminar fees should be excluded from the cap, even if a cap is introduced, the whole of the professional membership fee should remain fully deductible.

Other requirements

The Joint Bodies agree with the preservation of the existing requirements for claiming education expenses as noted in paragraph 52 of the Discussion Paper. However, should a cap be introduced, we strongly recommend Treasury consider indexation of

²³ The question arises whether many such publications, including their online services, will be an "education expense" in any event. Where the materials are used for reference in relation to specific work-related activities, they should properly be regarded as being akin to tools of trade. This potentially casts further doubt on the statistical information derived from expenses claimed under Item D5 to justify the proposed measures.

the cap or a mechanism for a periodic increase in the cap to reflect changes in costs associated with education expenditure that are likely to increase over time²⁴.

2. \$250 no-claim threshold

Under section 82A of the 1936 Act, the first \$250 of expenditure on education, defined as “expenses of self-education”, is not deductible and the amount of expenditure above this amount is deductible under the general deduction provision, section 8-1 of the 1997 Act.

This no-claim threshold was introduced into the tax legislation in 1975 to reflect a taxpayer’s entitlement to the concessional expenditure rebate available under former section 159N²⁵ of the 1936 Act, which was repealed in 1985. At the time of repeal, amendments were made to section 82A to redefine terms used in section 82A so that their definitions no longer referred to sections that were being repealed. However, the \$250 no-claim threshold was maintained. It is not clear why the Government of the time chose to maintain the no-claim threshold. No evidence is provided in the Explanatory Memorandum to the amending Bill²⁶ or the Second reading speech.

TR 98/9 indicates that it is not necessary that “expenses of self-education” to which section 82A applies be deductible; they must just be “necessarily incurred” for or in connection with a prescribed course of education²⁷. In this regard, expenses that are not deductible under section 8-1 can still be used to work out total expenses of self-education to which the no-claim threshold will apply. Expenses which are already non-deductible can be applied against the no-claim threshold such that potentially none of the no-claim threshold will be available to restrict the deduction of expenses that are otherwise deductible. In this regard, the no-claim threshold is ineffective in limiting the deduction of otherwise deductible expenses and positively contributing to revenue.

Given the current proposal involves imposing a \$2,000 cap on self-education expenditure, should the \$250 limitation also be maintained, expenditure that falls within the current definition of “expenses of self-education” in section 82A will effectively be limited to \$1,750.

Maintaining the \$250 no-claim threshold adds a layer of complexity to the administration of this deduction and effectively reduces the available deduction. As the nature of the availability of a deduction for education expenses is currently being reviewed, it is appropriate that the effectiveness of section 82A also be reviewed. In the interests of simplicity in redefining the parameters of the education expense deduction, section 82A should be repealed. Its relevance is historical, it is ineffective in positively contributing to revenue and it does not have any practical application today, particularly in the context of the proposed capping measure.

²⁴ For example, as a result of inflation.

²⁵ Section 159N in its current form was introduced in 1993 and refers to the \$445 rebate for low income earners.

²⁶ *Tax Laws Amendment Bill (No. 2) 1985* (Cth)

²⁷ Paragraph 29 of TR 98/9

Regardless of whether the capping measure is pursued, the Joint Bodies are of the view that section 82A is ineffective and should be repealed.

3. Sole traders

The Joint Bodies consider that the attempt to achieve “equal treatment” between employees and sole traders²⁸ is illogical. The income a sole trader derives is business income in nature and therefore very different in character to salary and wage income an employee derives. This is already recognised by Division 87.

An employee bears none of the risks of a sole trader. Rather, a sole trader bears more similar risks to a business. Sole traders incur expenditure that is typical of a business; employees do not. Therefore, the logical parallel to draw and the two entities between whom equality should be sought in respect of education expense deductions is between a sole trader and a business.

Drawing a parallel between employees and sole traders provides a perverse incentive that will influence choice of business structure. Professionals in some industries are permitted to trade through a corporate structure, but many make the choice to trade as a sole trader so as to reduce the regulatory burden on them. This is particularly the case for people in regional practice in low margin operations such as conveyancing and other commoditised work. This measure could well compel medical practitioners for example, who traditionally practice in a sole trader structure, to incorporate simply for the purpose of being able to claim unlimited education expenses through a corporate structure.

Other professionals, such as barristers, are only permitted to practice as sole traders and therefore do not have the choice available to them to convert to a corporate structure to facilitate claiming unlimited education expenses. This is a matter of law, not a matter of choice. Therefore, the proposed cap on education expense deductions will have a particular effect on barristers and sole solicitor practitioners who are required to finance their own education needs. It will result in the training and education obtained by them being much more costly than that provided to an employed solicitor.

Many barristers and sole solicitor practitioners will spend tens of thousands of dollars per year on legal texts, journals, online services and other such materials. Individual expenditure on these materials is essential to the practising lawyer as they are tools of the trade. Knowledge maintained through access to these materials is a tool of trade for lawyers in precisely the same way as a tradesperson’s tools are essential to their trade – it is impossible to properly do either job without them.

Under the proposal, where the tax deduction for subscribing to a daily current service or similar material will be subject to the proposed cap for a barrister or sole trader

²⁸ Refer to paragraph 56 of the Discussion Paper

solicitor, the employer of an employed solicitor will be able to obtain a full tax deduction for subscribing to the same service or materials. As noted above, one such subscription might absorb most, if not all, of the \$2,000 cap resulting in all other expenditure by a sole trader on required continuing professional education being non-deductible. This is plainly inequitable. Expenditure on these materials should accordingly be deductible as work-related expenses in the way they currently are without being subject to a cap.

Implementation of a cap risks undoing steps that have been taken towards achieving competitive neutrality between professions, and may provide incentives for professionals who are unable to incorporate to leave their disciplines, or perhaps not maintain specialist accreditations or specialist practices. Sole traders more generally may be forced to attempt to increase their fees (in the face of a very difficult and competitive market) to cover this aspect of their business expenses that will consequently increase as a result of this measure.

Given no limitation on the deduction for education expenditure is to be applied to businesses (subject to the comments on fringe benefits tax below), similarly no limitation should apply to the deduction for education expenditure incurred by sole traders. In this regard, it is not appropriate to apply the cap on education expenditure to sole traders who inevitably incur education expenditure as a necessary part of their business income-producing activities.

4. Personal services income

A more logical parallel to draw is between an employee and an individual deriving personal services income (**PSI**) outside of a personal services business. This is a circumstance where an attempt may be made by an individual to restructure to avoid the proposed cap. It is proposed in the Discussion Paper that the individual generating PSI outside of a personal services business would be prevented from claiming education expenses exceeding the cap through their personal services business. This addresses a potential integrity issue that may arise should the cap be introduced.

5. Depreciation

It is proposed that depreciation expenses associated with assets (such as a computer) that relate to an education activity be included in the cap on self-education expenses. As noted above, depreciation expenditure for a computer used for education purposes could be included under a cap.

Depreciation of a computer used for education purposes should be included under the cap if the computer is used solely for education purposes or partly for education and partly for private or domestic purposes (in which case apportionment will need to apply). In the case of a sole trader who will likely use the same computer for business, education and private purposes, it may be reasonable to only require apportionment between the private and non-private purposes and depreciate accordingly. It adds an unnecessary layer of complexity if a portion of the value of the computer attributable to

education needs to be segregated in this circumstance. This is consistent with our view that it is inappropriate to apply a cap on education expenses to sole traders.

6. International experience/comparison

At paragraph 25 of the Discussion Paper, reference is made to the treatment of education expenses in some comparable international jurisdictions with the accompanying statement that the treatment in Australia is generous. In support of this, information included in the Henry Review²⁹ is referenced.

This information was used to compare Australia's work-related expense deductions with other comparable jurisdictions. Drawing upon this information, the Henry Review recommended that a standard deduction should apply to work-related expenses, including education expenses, or allow claims for fully substantiated actual expenses above the claims threshold. In addition, the Review noted there should be a tighter nexus between the deductibility of the expenses and its role in producing income. Please refer to our earlier comments in relation to the Henry Review above.

The information referred to at paragraph 25 supports the position that a narrowing of the availability of a deduction for education expenses in Australia could be considered when the deduction permitted in Australia is compared to some of our international counterparts. However, it does not support the position that a blanket cap on education expenditure should be imposed. Imposition of a cap is a simplistic, if not literal, response to the issue of whether the current deduction in Australia's tax system should be limited without due regard to all the factors that contribute to the suggestion of "generosity" of the deduction.

7. FBT treatment – otherwise deductible rule and salary packaging

The Joint Bodies are concerned that the proposed FBT implications announced in the Media Release and how these have been explored in the Discussion Paper are both confused and inconsistent.

Otherwise deductible rule

Currently, education expenses incurred by an employer for the purpose of providing education to an employee are not subject to FBT (for example as an expense payment fringe benefit) by operation of the "otherwise deductible" rule. The threshold for self-education expenses contained in section 82A of the 1936 Act is disregarded for this purpose³⁰.

It is proposed that the otherwise deductible rule may no longer apply to education expenses incurred by an employer which exceed the proposed \$2,000 cap, resulting in employers being liable to FBT on education expenses which exceed the cap. Firstly,

²⁹ Refer to the Henry Review Part 2 Vol 1 p54

³⁰ Section 24(1)(b) and (ba) of the *Fringe Benefits Tax Assessment Act 1986* (Cth) (**FBTAA**)

we assume that the cap is intended to apply per individual employee. Secondly, we note that this statement is completely inconsistent with the parameters of the measure set out in the Media Release where the following statement was made:

Currently, employers are not liable for fringe benefits tax for education and training they provide to their employees – this treatment will be retained, unless an employee salary sacrifices to obtain these benefits. This is in recognition of the need to encourage employers to continue to invest in the skills of their workers.

We disagree with the proposal to impose FBT on education expenses incurred by an employer for an employee over and above the cap. This is completely inconsistent with the policy statement made in the Media Release referred to above. We also note several inconsistencies in the Discussion Paper. Paragraph 68 says employers may be subject to FBT. Paragraph 70 says categorically the Government will ensure no FBT liability arises for employers where they provide education expense payment fringe benefits. Example 5 states that the employer is able to claim the full \$3,600 deduction and will not be liable for FBT. If FBT were to be imposed, the Example should state that the employer is liable for FBT on the \$1,600 which exceeds the \$2,000 cap.

The position taken by Treasury in the Discussion Paper is both confused and also inconsistent with the policy statement contained in the Media Release. In our view, consistent with current treatment, FBT should not apply to the provision of education fringe benefits by employers as it will make the provision of education to employees too costly for employers.

Salary packaging

Currently, where an employee salary-sacrifices education expenses under an effective salary sacrifice arrangement, the employer is not usually subject to FBT on the benefit provided³¹.

Under the proposal, education expenses that are salary-sacrificed are to become subject to FBT and the “otherwise deductible” rule is to have no application. It appears FBT is to apply to the whole of the education expense salary sacrificed, rather than the amount which exceeds the proposed cap.

To achieve some parity in treatment between employees who salary sacrifice education expenses and those who incur the expenditure themselves, FBT should only apply on the amount which exceeds the proposed cap. Otherwise, this will discourage employers from supporting employees to obtain even the minimum education the employee is required to obtain to maintain their knowledge and skills in their profession. This also seems to be inconsistent with the idea that employers are still to be encouraged to provide education to their employees.

³¹ This is because the employee would otherwise be entitled to a deduction if they had incurred the expense.

Proposed legislative amendments to FBTAA

Appropriate amendments to the FBTAA will be required to reflect the proposed changes to FBT treatment for employer-provided education.

8. Income tax law amendments

If it is determined that a cap on education expense deductions should be introduced, a very carefully drafted specific legislative amendment should be included in Division 26 of the 1997 Act. Until the ambit of such a provision is fully determined, the Joint Bodies refrain from commenting on the wording suggested by Treasury at paragraph 78 of the Discussion Paper. However, we would willingly partake in any consultation process.