3 Methodology

3.1 Defining benchmarks

What is a tax expenditure benchmark?

A basic requirement in any analysis of tax expenditures is to identify the regular taxation arrangements that apply to similar classes of taxpayers or types of activity. These arrangements — referred to as the benchmark — represent a reference point against which to establish the nature and extent of any concession. Tax expenditures are defined as deviations from the benchmark.

Establishing an appropriate benchmark for determining tax expenditures often involves an element of judgement: benchmarks may vary across countries and within countries over time. The principal criterion of benchmark design is that it should represent a consistent taxation treatment of similar activities or classes of taxpayers. That is, a benchmark taxation treatment should neither favour nor disadvantage similarly placed activities or classes of taxpayers.

For example, the allowance granted to Australian primary producers to average their yearly incomes over time is a tax benefit not available to all income taxpayers. In this case, the estimated benefit to primary producers is measured by comparing the income tax they pay against the income tax paid by other taxpayers with similar incomes that are ineligible to access this concession. The benchmark is the income tax rate structure that would generally apply to yearly income.

Since the vast majority of Australian taxes are imposed on 'income' (as opposed to consumption), the definition of income used is important in determining what constitutes a tax expenditure. In this Statement, the framework for defining income is the Schanz-Haig-Simons (SHS) definition, which is the increase in economic wealth between two points in time, plus consumption in that period. In this definition of income, 'consumption' includes all expenditures, except those incurred in the earning or the production of income.

The approach to benchmarking in this Statement

A practical approach to defining benchmarks has been adopted in this Statement since the adoption of an ideal benchmark based on the pure SHS definition of income would result in many additional tax expenditures of little policy relevance. In particular, provisions considered to be intrinsic to the operation of the tax system have been incorporated into the benchmarks, rather than being classified as tax expenditures themselves. However, where the inclusion of a feature of the tax system in the benchmark is questionable, that feature has generally been excluded from the benchmark and reported as a tax expenditure.

Some features of the tax system have been incorporated into the benchmark as a practical necessity. For example, taxing unrealised gains on a large range of assets and taxing the imputed rent from consumer durables would not be practical. Hence, these features form part of the benchmark.

For the purpose of providing a clear structure for the reporting of tax expenditures, five major components of the benchmark have been identified. These are: the personal income tax benchmark; the retirement benefits benchmark; the fringe benefits tax benchmark; the business tax benchmark; and the excise duty benchmark. Although the association of some tax expenditures with a particular benchmark may be arbitrary, it does not affect the measurement or existence of a tax expenditure.

- The business tax benchmark and the personal income tax benchmark are not mutually exclusive. The distinction when identifying tax expenditures against these benchmarks is that income derived from investment and production based activities for all types of taxpayers is reported against the business tax benchmark. (The key exception is investment related to retirement benefits, which is treated under the retirement benefits benchmark.)

3.2 General features of the taxation benchmark

The following features are universal to all major components of the benchmark:

- The accounting period is the single financial year.

    - Averaging provisions, available only to selected classes of taxpayers (such as primary producers) are regarded as tax expenditures. However, carry-forward loss provisions are considered to be a part of the benchmark.

- A nominal, rather than real, income benchmark is adopted with some ad hoc adjustments for inflation.

- Income is assessed on a Tax Liability Method (TLM) accrual basis (see chapter 5.2 for further information). However, those provisions where income is assessed on a realisation basis (for example, under the capital gains provisions of the *Income Tax Assessment Act 1936*) are considered to be intrinsic features of the tax system and hence are incorporated into the benchmark.

3.3 The personal income tax benchmark

The following features are a part of the personal income tax benchmark (and therefore are not identified as tax expenditures):

- The legislated progressive personal income tax rate scale, including the tax-free threshold and Medicare levy.
  - The income tax rebate for low-income earners has been excluded from the benchmark, and therefore identified as a tax expenditure, on the grounds that it provides assistance to a distinct class of taxpayer and could be replaced by a direct expenditure.
- The individual is the tax unit.
  - Consequently, tax expenditures are deemed to arise where taxpayers' liabilities are modified according to their dependant-care responsibilities, for example the dependent spouse tax offset (A37).
- Imputed rent from owner-occupied housing and the income received from inheritances are not taxable. The expenses incurred in earning imputed rent are not deductible.
- Personal cash transfers[1] (including any refundable tax offset equivalents[2]) are taxable.
  - Therefore, any non-refundable tax offsets or exemptions from tax are treated as tax expenditures.
  - From the 2002-03 Budget, refundable tax offsets are identified as an expense and are therefore no longer treated as tax expenditures. Prior to that time they were treated as either expenses or tax expenditures.
- Australian residents are assessed on their worldwide income. Foreign tax credits are provided up to the amount of Australian tax payable in respect of the Australian resident's foreign income. Non-residents are taxed on Australian source income only. Specific rules deal with arriving and departing residents and intermediate categories of residence such as temporary residents.
- Exemptions are provided for sovereign immunity and some international taxation rights.
- Expenses incurred in earning assessable income are deductible. The main exceptions, where they are treated as tax expenditures, are:
  - deductions for depreciation if they provide more generous treatment than effective life depreciation;

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1 Personal cash transfers are cash payments from the Government to individuals not for services rendered.

2 Unlike an ordinary tax offset, a refundable tax offset is paid even if an individual does not have a tax liability. It is essentially a cash payment from the tax system. Examples include the Family Tax Benefit and the Private Health Insurance tax offset, which can be paid either as an expense or through the tax system.

- provisions that defer deductions, which are identified as negative tax expenditures; and
- deductions claimed on the basis of statutory formulae which yield a larger deduction than the actual cost incurred.

3.4 The retirement benefits benchmark

The following features are a part of the benchmark for retirement and other employment termination benefits:

- Remuneration in respect of employment is deductible for taxable employers and fully taxed to the employee.
- Additions to savings are financed out of after-tax income.
- Investment income on savings is taxed in the income year it is derived.
- Capital gains are subject to full taxation at the time of realisation. This corresponds with the treatment of capital gains earned by companies under the business tax benchmark.
- Savings (including interest) that have already been taxed are not taxed upon withdrawal.

3.5 The fringe benefits tax benchmark

The following features are a part of the fringe benefits tax (FBT) benchmark:

- FBT applies to all non-salary and non-wage benefits provided to employees or associates (except where their wage or salary income is exempt from personal income tax). All employers providing such benefits are liable for FBT.
- FBT is levied at the maximum personal tax rate, including the Medicare levy.
  - Although potential negative tax expenditures arise where employees, who receive fringe benefits, face marginal personal tax rates below the maximum rate, this feature is accepted as part of the benchmark as the effective administration of FBT requires that it be levied at a single rate.
- The benchmark value of a fringe benefit to an employee is taken to be its market value less any contribution paid by the employee.
  - In some cases, statutory formulae are available to calculate the taxable value of the benefit. As for the substantiation rules, tax expenditures are deemed to arise where the formulae provide a concession to taxpayers, such as the application of the formula to value car benefits (C32).

FBT is applied to the tax inclusive value of the fringe benefits and is deductible to the employer. From 1 July 2000, a grossed-up rate, inclusive of GST, applies to the provision of benefits to an employee where those benefits would attract GST if acquired directly by the employee. A special rebate applies to non-government entities that are exempt from income tax but subject to FBT and this rebate is treated as a tax expenditure.

3.6 The business tax benchmark

The following features are a part of the business tax benchmark:

- Capital gains tax (CGT) applies to the full consideration of realised nominal gains and losses. (This is consistent with the treatment of capital gains and losses of companies where assets are acquired after 21 September 1999.)

  - The following exemptions are also considered to be intrinsic features of the tax system and are included as a part of the CGT benchmark:

    : CGT exemption for gains on assets acquired prior to 20 September 1985;

    : CGT exemption for gains received by way of compensation or damages for any wrong or injury suffered by a taxpayer;

    : CGT exemption of gains or winnings from gambling; and

    : CGT roll-over relief on the death of a taxpayer, or the transfer of assets between spouses upon breakdown of marriage.

  - However, capital receipts that are specifically exempt under the CGT provisions are classified as tax expenditures, such as the CGT exemption for cultural bequests and cultural gifts (D35).

- Expenses incurred in earning assessable income are deductible, broadly in accordance with the change in value over the life of the service or asset purchased.

  - Provisions that defer deductions are identified as negative tax expenditures.

  - For depreciable assets, the benchmark is effective life depreciation.

  - The benchmark for advance expenditure (prepayments) on services is generally full apportionment over the service period.

  - Where an asset is held for both income-producing and private purposes, deductions should be limited to the portion of expenses relating to the monetary income.

- The benchmark incorporates the imputation system of company taxation.

  - Under imputation, the value of concessions is offset to some degree since such concessions reduce company tax paid. The subsequent taxation, in the hands of shareholders, of dividends paid out of tax-preferred income (as also occurred under the classical system) is generally not costed in this Statement because of the practical difficulties in doing so.

  - The taxation treatment of co-operative companies departs from the taxation of other companies under the imputation system. Tax expenditures arise where the income and distributions of co-operative companies receive concessional treatment.

- The taxation rules that apply to sole traders, partnerships and trusts, which are not separate taxable entities, are regarded as design features of the tax system.

- From 1 July 2002, wholly owned groups that consolidate will be treated as a single entity for income tax purposes. Consolidated groups can transfer assets and tax attributes within the group without any income tax consequences.

  - Transitional provisions extend access to the grouping rules for wholly owned company groups that do not consolidate from 1 July 2002.

- From 1 January 2003, investment income derived by friendly societies that is attributable to Income bonds, Funeral policies and Scholarship plans that currently qualifies for exemption from tax will be assessable. Friendly societies will be entitled to a deduction for the investment component of the benefits paid out to policyholders (other than benefits paid from scholarship plans that are returned to investors rather than being applied for the benefit of nominated students). A deduction will also be allowed for benefits applied to nominated students under scholarship plans that are currently subject to tax.

- Separate income tax scales are applicable to non-resident individual taxpayers.

- The dividend withholding tax (DWT), interest withholding tax (IWT) and royalty withholding tax (RWT) to the extent they apply to non-residents generally are included in the benchmark. The allocation of taxing rights in Australia's double tax agreements (other than tax sparing provisions) are also intrinsic to the tax system.

- Foreign Dividend Account, any Foreign Income Account provisions (from introduction) and the exemption from IWT for interest paid to non-residents by an offshore banking trust.

- Foreign-source income is taken to be assessed for residents on a worldwide basis, with a limit on foreign tax credits to the amount of Australian tax payable in respect of the foreign income. Tainted income (that is, passive income such as interest, royalties and dividends, and highly mobile forms of active income) is assessed on an accrual basis. Most active foreign-source income is assessed on a repatriation basis with a credit for any foreign tax paid (that is, the foreign tax credit system (FTCS) is applied).

  - An exemption from the operation of the FTCS is provided for branch income and certain non-portfolio dividends derived in a listed country. There is a tax expenditure for the amount that foreign company tax, plus DWT, is less than the amount of Australian tax payable.

  - Most tainted income derived by controlled foreign companies in broad exemption-listed countries is exempt from accrual taxation on the presumption that it has been comparably taxed. There is a tax expenditure for the difference between foreign tax paid on a current basis and what would have been payable in Australia.

  - Under the transferor trust rules, the amount of income available for distribution from the trust is taxed on an accrual basis. It is assumed that transferor trusts are used as passive investment vehicles and not for the conduct of active businesses. Most of the income of transferor trusts in broad exemption-listed countries is exempt from accrual taxation on the presumption that it has been comparably taxed. There is also a tax expenditure for the amount that foreign tax paid on a current basis is less than would have been payable in Australia.

  - The benchmark for taxing foreign investment fund (FIF) interests is the taxation on an accrual basis of the amount of passive income available for distribution from the FIF to

the Australian investor. The active income derived by the FIF and distributed to the Australian investor is taxed on a repatriation basis.

- The mutuality principle, which treats certain receipts as not being income, applies to non-profit associations and societies.

  - However, the global income tax exemptions for the income of specified non-profit organisations (for example, trade unions, cultural and sporting societies), which extend, for example, to investment income and income from business activities in competition with taxable entities, are treated as tax expenditures.

- Exemptions are provided for sovereign immunity and some international taxation rights.

- From 1986-87, the benchmark for unprocessed petroleum products (crude oil, condensate, liquefied petroleum gas and ethane) produced in offshore areas under the Commonwealth's jurisdiction is petroleum resource rent tax. The benchmark for petroleum products produced in projects that commenced prior to 1 July 1986 is crude oil excise, which may continue to apply unless taxpayers elect to pay petroleum resource rent tax.

3.7 The excise duty benchmark

The following features are a part of the excise duty benchmark:

- There are no exemptions for classes of taxpayers or activities.

- Imported petroleum, tobacco, beer, spirits and other excisable alcoholic beverages of an alcohol strength not exceeding 10 per cent, are subject to customs duty which is analogous to excise duty on these items.

- The excise rate on unleaded petrol (which is also the rate for diesel) is the benchmark for petroleum fuels.

  - The higher rates of excise on leaded petrol (up to 2000-01) and high sulphur diesel are recognised as negative tax expenditures (E1, E2).

  - The lower excise rates on fuel oil, heating oil, kerosene, aviation gasoline and aviation turbine fuel are recognised as tax expenditures (E5, E6).

  - The excise exemption for LPG is recognised as a tax expenditure (E4).

- The current excise rate on tobacco is the benchmark for all tobacco products.

  - Per stick taxation applies to cigarettes with up to 0.8 grams of tobacco per stick. The per stick excise rate on cigarettes with 0.8 grams of tobacco per stick is recognised as equivalent to the excise rate on loose tobacco and, therefore, is not a tax expenditure. However, the excise rate on cigarettes with less than 0.8 grams of tobacco per stick represents a negative tax expenditure (E3), compared with the excise rate on other tobacco products.

- There are currently five different benchmarks for alcohol, reflecting alcohol type.

- Three benchmarks for beer, comprising the current excise rates for full-strength, mid strength and low-strength beer, packaged in individual containers not exceeding 48 litres. The excise-free threshold of 1.15 per cent of alcohol, which applies to all beer, is included in all three benchmarks.

  : The excise rate applying to full strength beer, packaged in individual containers not exceeding 48 litres is also the benchmark for other excisable beverages of an alcoholic strength not exceeding 10 per cent.

- The current excise rate on spirits is the benchmark for spirits.

  : The lower excise rate on brandy is recognised as a tax expenditure (E7).

- The wine benchmark, which covers wine, alcoholic cider and other alcoholic products, is based on the wine equalisation tax (WET) (because these products are not subject to excise duty).

  : The Commonwealth WET cellar door rebate provided for certain direct sales by producers either at their premises, by mail order or over the internet, is recognised as a tax expenditure (E9).