CHAPTER 4: BENCHMARKS

4.1 Defining benchmarks

WHAT IS A TAX EXPENDITURE BENCHMARK?

A tax expenditure benchmark is a reference point against which the nature and extent of any concession can be identified. Tax expenditures are deviations from this benchmark.

The framework for defining the benchmarks used in this statement is based on two principles.

- First, the benchmark should represent the standard taxation treatment that applies to similar taxpayers or types of activity. Consequently, a benchmark taxation treatment should neither favour nor disadvantage similar taxpayers or activities.

- Second, the benchmark should incorporate *structural elements* of the tax system. Such elements could include longstanding or integral design features; for example, the progressive income tax rate scale for individual taxpayers.

Reconciling these two criteria often involves an element of judgment. In particular, there may be different views on which structural elements to include in the benchmark. Consequently, benchmarks vary over time and across countries.

To provide a clear structure for reporting tax expenditures, the benchmark is split into two major components reflecting Australia's taxation arrangements. The *income tax benchmark* describes the standard taxation arrangements applying to personal and business income, superannuation, fringe benefits and capital gains. The *commodity tax benchmark* describes the standard taxation arrangements that apply either directly or indirectly to specific commodities; namely tobacco, fuel, types of alcoholic beverages, motor vehicles and natural resources.

The remainder of this chapter provides details of the key elements of the income and commodity tax benchmarks. The discussion focuses on the following elements of each benchmark:

- the tax base — the activities or transactions subject to the tax;

- the tax rate — the rate of tax that applies to the base;

- the tax unit — the entity liable to pay the tax; and

- the tax period — the period in which the activities or transactions are undertaken.

4.2 Income tax benchmark

Most Australian Government taxes are imposed on income rather than commodities. The following sections outline the general features of the income tax benchmark. The benchmarks for superannuation, fringe benefits and capital gains are discussed separately because they have distinct tax regimes that affect how tax expenditures are measured against the general income tax benchmark.

GENERAL FEATURES

Tax base

The tax base for the income tax benchmark is based on the Schanz-Haig-Simons definition of income.[1] An entity's income is defined as the increase in the entity's economic wealth (stock of assets) between two points in time, plus the entity's consumption in that period. Consumption includes all expenditures, except those incurred in earning or producing income.

The Schanz-Haig-Simons definition of income conforms to the principal criterion of benchmark design: all income is included in the base regardless of the income earning activity. Adopting a benchmark based on this definition would exclude structural elements of the current tax system. Consequently, the income tax benchmark is based on the Schanz-Haig-Simons framework, but modified to accommodate structural elements.

Under the income tax benchmark, income includes:

- wages and salaries;
- allowances;
- business receipts;
- capital gains;
- interest, royalties and dividends;

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1 Further information on the Schanz-Haig-Simons and other definitions of income can be found in J King, 'The Concept of Income', *Tax Policy Handbook*, International Monetary Fund, Washington DC, 1995, p 117.

- partnership income;
- government cash transfers[2]; and
- distributions from trusts.

Under the income tax benchmark, expenses incurred in earning income are deductible at historical cost. Where an expense is incurred for both income-producing and private purposes, deductions are limited to the portion of expenses relating to income production.

A number of tax arrangements depart from the Schanz-Haig-Simons definition of income but are structural features of the tax system and therefore included in the benchmark. These elements are outlined below.

- Assessment applies to nominal rather than real income.
- Some taxpayers (typically individuals) recognise income when it is actually received (cash basis) and other taxpayers (typically businesses) recognise income when there is a right to receive benefits (accrual basis).
- Deductions for expenses related to economic benefits that extend beyond the income year in which the expenditure is incurred are spread over the period of the benefits.
- Imputed rent from owner-occupied housing is not included in income, and expenditure incurred in earning imputed rent is not deductible.
- The mutuality principle excludes income from dealings with oneself or members of mutual associations and societies. For instance, goods produced by taxpayers for their own consumption, or services performed by taxpayers for their own benefit are generally not included in the tax base.
- Certain gains, such as gains received by way of compensation for damage or any wrong or injury suffered by a taxpayer (where they are not solely for the loss of income), or gains or winnings from gambling (where taxpayers are not considered to be carrying on a business of gambling), are not included in income.

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2 Cash transfers are payments from the Australian Government to individuals or businesses which are not for services rendered (including refundable tax offsets). These transfers are included in the income tax benchmark. Non-cash government transfers such as the provision of health, education or road services are not included in the definition of income.

- Investment income derived from income bonds, funeral policies and scholarship plans of friendly societies that were issued before 1 January 2003 is not included in income.
  - Income relating to policies issued after 1 January 2003 is included in a friendly society's assessable income.
  - To prevent double taxation of income from bonds, funeral policies and scholarship plans, friendly societies can deduct the investment component of the benefits paid out to policyholders (other than the benefits from scholarship plans that are returned to investors rather than paid to the nominated students).
- Losses are deductible against assessable income for a later income year. Losses generally cannot be transferred to other taxpayers, and some losses may only be claimed against certain types of future income (for example, the quarantining of capital losses).
- Depreciation deductions are made over the effective life of the asset.
- Advance expenditure (prepayments) for services are generally apportioned over the service period. These apportioned amounts are deductible.
- From 1 July 2005, under a provision of last resort, business capital expenditures not elsewhere recognised within the taxation laws (blackhole expenditures) are deductible over five years.

Arrangements to prevent double taxation

Arrangements to reduce or eliminate double taxation are integral features of the tax system and are included in the benchmark.

- For example the imputation system, which eliminates the double taxation of company profits distributed to shareholders, is included in the income tax benchmark.

International tax arrangements

Different definitions of income apply to residents and non-residents.

Australian residents are taxed on their worldwide income under the income tax benchmark. Consequently residents are taxed on their domestic and foreign-source income. Various international tax arrangements which ensure foreign-source income is subject to appropriate Australian tax are included in the income tax benchmark. These arrangements are noted below.

- Resident taxpayers are allowed to claim foreign tax credits up to the amount of Australian tax payable on foreign income. These arrangements ensure foreign source income is not taxed twice, firstly when earned overseas, then again in Australia.
- The controlled foreign company, foreign investment fund and transferor trust rules ensure Australian residents cannot escape or defer taxation of tainted income by interposing a non-resident legal entity.
  - Tainted income is generally income derived by investments which are mobile and whose location probably was influenced primarily by tax considerations. It includes passive income such as interest, royalties and dividends, and highly mobile forms of active income.

Non-residents are taxed on their Australian-source income only. Where a distribution paid to a non-resident from Australia is a distribution of foreign income or capital gains earned by an Australian entity, the distribution is not subject to Australian taxation. This avoids taxing the non-resident on what is essentially foreign income. The exemption is part of the benchmark.

Transfer pricing and thin capitalisation rules and interest, dividend and royalty withholding taxes aim to tax appropriately Australian sourced income, and so are included in the benchmark.

The benchmark also includes the allocation of taxing rights in Australia's double tax treaties (other than tax sparing provisions) which are longstanding or integral features of the tax system. These arrangements provide greater certainty for taxpayers by determining which jurisdiction has the right to tax various categories of income.

Tax rates and income brackets

The tax rate under the income tax benchmark is the legislated tax rate that applies to the relevant entity in each financial year.

The personal income tax system includes the tax-free threshold, the progressive personal income tax rate scale and the Medicare levy. The progressive income tax rate scale is an integral and longstanding feature of the tax system.

Non-residents are not entitled to a tax-free threshold on Australian sourced income, as they typically receive a tax-free threshold in their home jurisdiction. As a result, the non-resident income tax scale is included in the benchmark.

Tax unit

Individuals and companies are subject to tax under the income tax benchmark. Sole traders, partnerships and trusts are not separate tax units. Income earned by these entities is taxable in the hands of the recipient.

For the personal income tax system in Australia, the benchmark unit is the individual.

For companies, the benchmark tax unit is the company. From 1 July 2002, the benchmark tax unit for companies also includes the head entity of a consolidated group or a multiple-entry consolidated group.

Taxation period

The taxation period adopted under the income tax benchmark is the financial year (1 July to 30 June). Consequently, measures that defer taxable income to another financial year such as income averaging for primary producers (B82) or the farm management deposit scheme (B83) are reported as tax expenditures. Tax deferral arrangements will generally give rise to tax expenditures in the year income is earned, offset by a negative tax expenditure when the income is taxed.

Departing from this framework, the carry-forward loss provisions are an integral feature of the tax system and are included in the benchmark. These provisions allow an entity with a loss to carry the loss forward and deduct it in the future.

The benchmark also includes arrangements for entities whose accounting period differs from the standard financial year (for example, companies with a substituted accounting period).

General features of the income tax benchmark

The personal income tax benchmark comprises:

- a tax base including all nominal income less expenses incurred in earning income;
- a tax scale comprising tax rates and associated income tax thresholds;
- the individual as the tax unit; and
- the financial year as the tax period.

The business income tax benchmark comprises:

- a tax base including all nominal income less expenses incurred in earning income;
- a tax rate as the rate that applies to the entity;
- the individual company (or head entity of a consolidated group) as the tax unit;
- the dividend imputation system, which ensures that company profits distributed to resident shareholders are taxed at the shareholders' marginal rate of tax; and
- the financial year (or substituted accounting period) as the taxation period.

SUPERANNUATION BENCHMARK

Income contributed to superannuation funds (contributions) and earnings of superannuation funds are classified as income under the Schanz-Haig-Simons definition. While such income could be considered under the personal income and capital gains tax benchmarks, the unique (and concessional) taxation treatment of superannuation warrants further detail on how the general income tax benchmark is applied to superannuation.

Superannuation in Australia may be taxed at three stages:

- when contributions are made to a superannuation fund;
- when investments in superannuation funds earn income; and
- when superannuation benefits are paid out.

Under the benchmark taxation treatment of superannuation, contributions are taxed like any other income in the hands of the fund member, earnings are taxed like any other investment income in the hands of the investor and benefits from superannuation are untaxed. Costs associated with superannuation investments are deductible under the benchmark.

Special features of the superannuation benchmark

The superannuation benchmark comprises:

- contributions taxed in the hands of the fund member;
- earnings taxed like any other investment income in the hands of the investor; and
- benefits from superannuation untaxed.

FRINGE BENEFITS TAX BENCHMARK

Fringe benefits are classified as individual employee income under the Schanz-Haig-Simons definition. This section defines the benchmark for the fringe benefits tax system drawing on the general features of the income tax benchmark outlined above.

The tax base for the fringe benefits tax benchmark is fringe benefits provided to an employee or an associate of an employee in respect of the employment of the employee. Fringe benefits include property rights, privileges or services. Payments of salary or wages, eligible termination payments, contributions to complying superannuation funds and certain benefits arising from employee share schemes are excluded. The benchmark value of a fringe benefit to an employee is taken to be its market value less any contribution the employee pays. Generally, employers may claim the cost of providing fringe benefits and the amount of fringe benefits tax paid as income tax deductions.

The tax rate that applies under the fringe benefits tax benchmark is equivalent to the top personal marginal income tax rate plus the Medicare levy.[3] This is a longstanding and integral feature of the fringe benefits tax system. Fringe benefits tax is calculated on the grossed up taxable value (that is, the pre-tax equivalent value) of the fringe benefit. In some cases, discount valuation methods are available to calculate the taxable value of a fringe benefit. Such methods are reported as tax expenditures.

3 The higher rate of tax on fringe benefits provided to employees who are not in the top marginal tax bracket is considered part of the benchmark.

The employer providing the fringe benefit (rather than the employee receiving the benefit) is the tax unit under the benchmark. This is consistent with the legal incidence of fringe benefits tax, which is payable by employers. The benchmark tax period is the fringe benefits tax year (1 April to 31 March).

Special features of the fringe benefits tax benchmark

The fringe benefits tax benchmark comprises:

- a tax base including all benefits provided to an employee or an associate of an employee in respect of the employment of the employee;
- generally, a deduction to the employer for the cost of providing fringe benefits and the amount of fringe benefits tax paid;
- the tax rate equivalent to the top personal marginal income tax rate plus the Medicare levy;
- the employer as the tax unit; and
- the fringe benefits tax year as the tax period (1 April to 31 March).

CAPITAL GAINS TAX BENCHMARK

Capital gains are classified as income under the Schanz-Haig-Simons definition. This section defines the benchmark for the capital gains tax system drawing on the general features of the income tax benchmark outlined above.

The tax base for the capital gains tax benchmark is realised nominal gains and losses. The benchmark only includes gains or losses arising from the realisation of property where the realisation is not an aspect of the carrying on of a business. This excludes gains or losses that form part of a business's normal trading activities from the capital gains tax benchmark, for instance, gains or losses on trading stock of a business and gains or losses realised in the business of trading particular assets. These gains or losses are dealt with under the general features of the income tax benchmark.

Capital gains are taxable upon realisation. While the taxation of gains on an accrual basis aligns more closely with the broad Schanz-Haig-Simons definition, taxation on a realisation basis is consistent with longstanding practice and recognises the administrative problems associated with an accrual system.

Consistent with the general features of the income tax benchmark, the benchmark for Australian residents is their worldwide capital gains. In the case of non-residents,

Australia will limit its domestic and treaty capital gains tax rules to the direct or indirect disposal of interests in Australian land (and similar interests such as mining rights) and branch office assets from 12 December 2006. This recognises that it is not effective or efficient to pursue broader capital gains taxing rights. In respect of both the foreign capital gains of residents and the Australian capital gains of non-residents, the allocation of taxing rights in the domestic laws and tax treaties is part of the benchmark.

The tax rate and tax unit adopted under the capital gains tax benchmark is the same as that which applies under the general benchmark outlined above.

Special features of the capital gains tax benchmark

The capital gains tax benchmark comprises:

- taxation of gains on a realisation basis (that is, at the time an asset is disposed of) rather than on accrual;
- a tax base as nominal gains or losses from the realisation of property where the realisation is not an aspect of the carrying on of a business; and
- the limitation of Australian taxation of the capital gains of non-residents to gains on the direct or indirect disposal of interests in Australian land (and similar assets such as mining rights) and branch office assets.

4.3 Commodity tax benchmark

The Australian Government imposes taxes on particular commodities. The tax base for the commodity tax benchmark is made up of two components.

- The consumption tax benchmark relates to the consumption of fuel (or energy), tobacco, types of alcoholic beverages and motor vehicles.
- The natural resource tax benchmark relates to the extraction and production of Australia's natural resources.

This statement only reports tax expenditures that relate to Australian Government taxes. The consumption tax benchmark does not include the GST. In addition, this statement excludes tax expenditures arising from the payment of customs duty except

to the extent that the duty concerned is analogous to an excise duty that applies to similar goods produced in Australia.[4]

CONSUMPTION TAX BENCHMARK

Consumption taxes are either *ad valorem* or volumetric. *Ad valorem* taxes are charged as a fixed proportion of the value of the commodity sold. Volumetric taxes are charged as a fixed proportion of the quantity of the commodity sold. Consequently, the tax base for consumption taxes is determined either by the value or quantity of the commodity sold.

The Australian Government imposes volumetric taxes on the consumption of tobacco, fuel, beer and spirits, and *ad valorem* taxes on the consumption of wine and luxury cars. These taxes are imposed at either the retail, manufacture or importation stage. In each case the tax unit is the entity that has the legal obligation to pay the tax.

The following sections outline how the general features of the consumption tax benchmark apply to the consumption of tobacco, fuel, alcohol and motor vehicles.

General features of the consumption tax benchmark

The consumption tax benchmark comprises:

- either the value or quantity of the commodity sold as the tax base;
- the rate of tax that applies to the price or quantity of the commodity sold as the tax rate; and
- the entity that has the legal obligation to pay the tax as the tax unit.

Tobacco

The benchmark for the consumption of tobacco (such as cigarettes and cigars) is the excise rate that applies to tobacco.

4 Estimates of the value of assistance provided to various industries, including tariff arrangements, appear in the Productivity Commission's *Trade and Assistance Review*.

Fuel (or energy)

The tax base for the consumption of all fuel (or energy) is split into two activities:

- fuels consumed in an internal combustion engine (that is, primarily for transport use); and
- fuels consumed for a purpose other than in an internal combustion engine (for example, a product that can be used as a fuel in an internal combustion engine but is used in a solvent application or for heating).

The taxation of these activities reflects longstanding and integral features of the tax system whereby excise rates are dependent on whether the fuel is used in an internal combustion engine.

The benchmark excise rates for fuels consumed in an internal combustion engine are the full energy content based rates set to apply from 1 July 2015, for the following bands:

- high-energy content fuels, with energy content of more than 30 megajoules per litre and excise rate of 38.143 cents per litre. These include fuels such as petrol, diesel, biodiesel and aviation fuel;
- medium-energy content fuels, with energy content between 20 and 30 megajoules per litre and excise rate of 25 cents per litre. These include fuels such as liquefied petroleum gas (LPG), liquefied natural gas (LNG) and ethanol; and
- low-energy content fuels, with energy content of less than 20 megajoules per litre and excise rate of 17 cents per litre. These include fuels such as methanol.

Fuels consumed other than in an internal combustion engine are exempt from excise under the benchmark.

Alcoholic beverages

The tax base for the consumption of alcoholic beverages is separated into three components based on the types of beverage:

- the consumption of lower alcohol content beverages (beverages with less than 10 per cent alcohol content) such as beer and ready to drink beverages;
- the consumption of higher alcohol content beverages (beverages with greater than 10 per cent alcohol content) such as brandy and other spirits; and
- the consumption of wine and alcoholic cider.

The taxation of these activities reflects a longstanding feature of the tax system whereby different tax rates apply to beer, spirits and wine:

- the benchmark excise rate for lower alcohol content beverages (for example, beer) is the excise rate that applies to full-strength packaged beer (including the excise-free threshold of the first 1.15 per cent of alcohol);
- the benchmark excise rate for higher alcohol content beverages (for example, spirits) is the excise rate on spirits other than brandy; and
- the benchmark rate for wine and alcoholic cider is the wine equalisation tax rate.

Motor vehicles

Motor vehicle purchases are not taxed under the benchmark. Consequently, the luxury car tax (F19) is a negative tax expenditure.

TAXES ON NATURAL RESOURCES (PETROLEUM)

The Australian Government taxes the extraction and production of unprocessed petroleum products (for example, crude oil, natural gas, ethane and LPG condensate). Different taxation arrangements for unprocessed petroleum products apply to projects that commenced from the 1986-87 financial year to those that commenced before.

- The benchmark for projects that commenced on or after 1 July 1986 is the petroleum resource rent tax.
- The benchmark for projects that commenced before 1 July 1986 is the crude oil excise.

These taxes are longstanding and integral features of the tax system and ensure the Australian community receives a return for the exploitation of non-renewable resources.

General features of the benchmark for the taxation of natural resources

The petroleum resource rent tax benchmark comprises:

- all income from offshore petroleum production less eligible project expenditures as the tax base;
- the petroleum resource rent tax rate (40 per cent) as the tax rate; and
- the entity that has the legal obligation to pay the tax as the tax unit.

The crude oil excise benchmark is comprised of the following features:

- the barrel equivalent production of crude oil from fields of greater than 30 million barrels as the tax base;
- the rate of tax that applies to crude oil as the tax rate; and
- the entity that has the legal obligation to pay the tax as the tax unit.