THE VICTORIAN BAR INCORPORATED

SUBMISSION TO THE HONOURABLE JOSH FRYDENBERG MP

2021-22 FEDERAL BUDGET - ADDRESSING THE TAX DEDUCTIBILITY OF CHILD CARE

INTRODUCTION

1. This submission by the Victorian Bar (***the Bar***), for consideration by the Commonwealth Government as part of its 2021-22 Budget process, addresses the tax deductibility of child care.

ACKNOWLEDGMENT

2. The Bar acknowledges the contributions of Susan Crennan AC QC, Jennifer Batrouney AM QC, Eugene Wheelahan QC, Nicholas Walter and Professor Ann O'Connell in the preparation and drafting of this submission.

OVERVIEW

3. The Bar submits that there are sound policy justifications for legislative reform to ensure that child care expenses are tax deductible. We recommend that the Commonwealth Government adopt the proposal advanced by University of New South Wales researchers, pursuant to which existing child care subsidy arrangements would be retained, but taxpayers would be given the option to choose either to receive the subsidy or to deduct child care expenses from their assessable income.[1]

4. Under this arrangement, deductions would be permitted for child care expenditure (including on in home care) up to $60,000 p.a., (with the deduction shared 50-50 in two parent households).[2] This would address the situation where parents receive no (or very little) assistance with child care expenses because their income exceeds the thresholds set by the Commonwealth Government.[3]

5. Such an approach would be consistent with recent suggestions by Government backbenchers[4] and analysis by leading academics.[5] It would lead to greater equality of opportunity for women, higher rates of participation in the workforce and increased productivity.

THE PRESENT STATE OF THE LAW

6. Section 8-1 of the *Income Tax Assessment Act 1997* (**ITAA**) relevantly provides that:

> *'(1) You can deduct from your assessable income any loss or outgoing to the extent that:*
> *(a) it is incurred in gaining or producing your assessable income; or*
> *(b) it is necessarily incurred in carrying on a business for the purpose of gaining*

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1 Rosalind Dixon, Richard Holden and Melissa Vogt, *(Un)taxing Child-care: Boosting Choice and Labour Supply through Subsidised and Tax-Deductible Child-care in Australia* (2020).

2 Ibid 20.

3 As to which, see section C.2 below.

4 See, eg, Katina Curtis, 'Government MPs put tax deductions for child care fees on the table' *Sydney Morning Herald* (16 November 2020).

5 See, eg, Professor Ann O'Connell and Professor Kerrie Sadiq, 'Lodge v Federal Commissioner of Taxation' in Heather Douglas et al (eds), *Australian Feminist Judgments* (2014) 85.

or producing your assessable income.

(2) However, you cannot deduct a loss or outgoing under this section to the extent that:

…

(b) it is a loss or outgoing of a private or domestic nature'.

7. Despite the crucial nature of the expense for working families, the deductibility of child care expenses has not been considered by the full bench of the High Court. Rather, the issue was considered by a single judge of the High Court in 1972 — almost 50 years ago, at a time when women were more likely to withdraw from the workforce when they had children.[6] In that case, *Lodge v Federal Commissioner of Taxation* (***Lodge***), Mason J held that child care expenses for a law costs clerk (who was a single parent who largely worked from home) were not deductible because they were not incurred '*in*' gaining or producing assessable income.[7]

8. The analysis of Mason J in *Lodge* relied principally on two cases: *Ronpibon Tin NL v Federal Commissioner of Taxation*[8] (***Ronpibon Tin***) and *Lunney v Federal Commissioner of Taxation* (***Lunney***).[9]

9. In *Ronpibon Tin*, the High Court said that:[10]

> '*For expenditure to form an allowable deduction as an outgoing incurred in gaining or producing the assessable income, it must be incidental and relevant to that end. The* ***words "incurred in gaining or producing the assessable income" mean in the course of gaining or producing such income.***' [emphasis added]

10. In *Lunney*, the High Court applied the test in *Ronpibon Tin* in holding that travel expenses to and from work were not deductible. As Mason J explained in *Lodge*:[11]

> '*The rejection in Lunney's case of the claim that the expenses of travelling between home and work was an allowable deduction was based upon a proposition that it was not enough to show that the expenditure was an essential prerequisite to the derivation of assessable income. The decision denied the notion that an expense was incidental and relevant to the derivation of income merely because it was necessary in that sense. The decision turned rather upon a view of the character of the expenditure incurred.* ***This approach to … [the predecessor of s 8-1 of the ITAA] is founded largely on the presence of the word "in" in the principal parts of the subsection.***' [emphasis added]

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6 See www.aifs.gov.au/publications/how-we-worked.

7 *Lodge v Federal Commissioner of Taxation* (1972) 128 CLR 171. The decision was made by a single judge of the High Court pursuant to an appeal from an objection decision of the Commissioner. Such an appeal would now be heard by the Administrative Appeals Tribunal or by the Federal Court.

8 *Ronpibon Tin NL v Federal Commissioner of Taxation* (1949) 78 CLR 47.

9 *Lunney v Federal Commissioner of Taxation* (1958) 100 CLR 478.

10 *Ronpibon Tin NL v Federal Commissioner of Taxation* (1949) 78 CLR 47, 56-57 (Latham CJ, Rich, Dixon, McTiernan and Webb JJ).

11 *Lodge v Commissioner of Taxation* (1972) 128 CLR 171, 175 (Mason J).

11. In *Lodge*, Mason J concluded:[12]

> '*In the light of the authoritative observations concerning … [the predecessor to s 8-1(1)] made by this Court in its earlier decisions, I have no alternative but to arrive at the conclusion that the appellant's claim in this appeal cannot succeed.*'

12. Mason J left open the question whether child care expenses would be '*private or domestic*' in nature if they were found to be incurred in gaining assessable income.[13] (We note that in the more recent case of *Federal Commissioner of Taxation v Anstis*, the High Court referred with approval to an observation that '*[i]t must be a rare case where an outgoing incurred in gaining assessable income is also an outgoing of a private nature*'.[14]) Thus if it were established that a particular taxpayer's child care expenses were incurred in producing assessable income (and met the requirements in section 8-1(1)), it is unlikely that they would be held to be of a '*private or domestic nature*' because they were expenses incurred for income-earning purposes.)

13. The analysis of Mason J in *Lodge* (based on *Ronpibon Tin* and *Lunney*) has been considered and applied in subsequent cases concerning the deductibility of child care, including *Martin v Federal Commissioner of Taxation*[15] (**Martin**), *Hyde v Federal Commissioner of Taxation*[16] (**Hyde**) and *Jayatilake v Federal Commissioner of Taxation* (**Jayatilake**).[17] The judges in those cases considered that they were bound by *Lodge*. However, they did not accept the position without raising some concerns. For example:

    (a) in *Hyde*, a decision of the Federal Court, French J said:[18]

> '***It would be a mistake to elevate these cases which turn on their own facts to a statement of general principle that there could never be a situation in which child minding expenses are deductible****; however, to be deductible they would have to answer the description of being "incurred in gaining or producing the assessable income" and would have to fall outside the category of expenditure of a "private or domestic nature". ... **One can accept that the taxpayer may well feel some sense of grievance at the fact that the expenditure cannot be claimed as a deduction, but as the courts have said on occasions before today, the answer to that grievance will not be found in the courts but in changing the law and that is a***

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12 Ibid 175.

13 *Lodge v Commissioner of Taxation* (1972) 128 CLR 171, 176 (Mason J).

14 *Federal Commissioner of Taxation v Anstis* (2010) 241 CLR 443, 457 (French CJ, Gummow, Kiefel and Bell JJ), referring to the decision of *Federal Commissioner of Taxation v Hatchett* (1971) 125 CLR 494, 498 (Menzies J). See also *Federal Commissioner of Taxation v Finn* (1961) 106 CLR 60, 70 (Windeyer J).

15 *Martin v Federal Commissioner of Taxation* (1984) 2 FCR 260.

16 *Hyde v Federal Commissioner of Taxation* (1988) 18 ATR 1645.

17 *Jayatilake v Federal Commissioner of Taxation* (1991) 101 ALR 11.

18 *Hyde v Federal Commissioner of Taxation* (1988) 18 ATR 1645, 1647 (French J).

matter for the legislature.' [emphasis added]

(b) in *Jayatilake*, a decision of the Full Court of the Federal Court, Sweeney, Jenkinson and Hill JJ said:[19]

> '*If the law is to be changed to permit a deduction for child minding expenses … it is a matter for the legislature and not this court.*'

14. It is also notable that in *Lunney* — upon which the later decisions were based — Dixon CJ made the following observation:[20]

> '*Times have changed; the incidence of income tax greatly differs now in scope and weight from its incidence in the days when the law was settled; possibly, the justice of the traditional legal view is a little more open to question and certainly its financial significance supplies a motive for questioning it. … The question having been agitated it became necessary to turn to the Australian authorities by which it was settled long ago. It was surprising to find how few they were and that they depended rather upon their persuasive authority than their imperative character. … The relevant provisions of the English Income Tax Acts are not in the same terms as those of the Australian law, but the whole course of English authority involves a like conclusion. To escape from the course of reasoning on which the decisions proceed requires the taking of refined and rather insubstantial distinctions.* ***I confess for myself, however, that if the matter were to be worked out all over again on bare reason, I should have misgivings about the conclusion.*** *But this is just what I think the Court ought not to do. It is a question of how an undisputed principle applies. Its application was settled by old authority long accepted and always acted upon.* ***If the whole subject is to be ripped up now it is for the legislature and not the Court to do it.***' [emphasis added]

15. As explained by French J in *Hyde*, although there is no general principle that child minding expenses cannot be incurred in the course of gaining assessable income, and that the cases turn on their own facts, nonetheless, because of the decision in *Lodge*, child care expenses are generally regarded as not deductible.

16. The Bar submits that the time is ripe for this state of affairs to change.

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[19] *Jayatilake v Federal Commissioner of Taxation* (1991) 101 ALR 11, 16 (Sweeney, Jenkinson and Hill JJ).

[20] *Lunney v Federal Commissioner of Taxation* (1958) 100 CLR 478, 485-6 (Dixon CJ). While that case concerned the deductibility of travel expenses, it was (as set out at paragraphs 10 and 11 above) a key authority in the case of *Lodge v Commissioner of Taxation* (1972) 128 CLR 171.

JUSTIFICATION FOR LEGISLATIVE REFORM TO ENSURE DEDUCTIBILITY OF CHILD CARE EXPENSES

17. The Bar submits that it would be appropriate for tax deductions to be allowed for child care expenses. We analyse the proposed reform by reference to whether it is economically efficient, fair and simple: being the standard criteria for the assessment of tax reform proposals.[21] We also discuss briefly the budgetary effect of the reform and observe that the reform would assist the economy in recovering from the COVID-19 pandemic. Our observations are made at a conceptual level as we are not in a position to undertake detailed demographic, economic and revenue modelling or sociological research.

It would be economically efficient to allow deductions for child care

18. Making child care tax deductible would be economically efficient. It would increase the workforce participation rate[22] and promote competition between child care providers[23] — thereby lowering the cost of child care overall.

Increasing workforce participation

19. The high cost of child care has been identified as reducing the rate of participation in employment, particularly for a household's secondary income earner. The Productivity Commission said in 2014:[24]

> '*Australia's tax and transfer system creates a strong disincentive for some parents to enter the workforce or to increase their hours of work. For some second income earners (usually mothers) who return to work and use ECEC [early childhood education and care], the combination of a drop-off in Family Tax Benefits once family income rises, progressive income tax rates, reduced CCB [child care benefit] assistance at higher income levels and the cap on CCR [Child care Rebate] assistance, can result in an* ***effective marginal tax rate (EMTR) approaching 100 per cent****, particularly once work exceeds 3 days per week*'. [emphasis added]

20. If parents were given the option either to have access to the child care subsidy or to have a tax deduction, the problem of very high effective marginal tax rates would be lessened. This would likely increase workforce participation rates and overall productivity.[25]

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21 See, eg, K W Asprey et al, *Taxation Review Committee Full Report* (1975) [3.6].

22 See [20] below.

23 See [22] below.

24 Productivity Commission, *Report into Child care and Early Childhood Learning* (2014), vol 1, 13.

25 It may be that, for this reason, it is common for other advanced economies (including Canada, Belgium, Germany, Norway, Austria and France) to allow deductions or tax credits for child care: see Dixon, above n 1, 28.

21. Further, the current Commonwealth Government child care subsidy must generally be applied toward the provision of care in approved child care facilities.[26] The exigencies of some professions or occupations are not always compatible with standard child care facilities. If deductions were allowed both for expenditure at approved child care facilities and for expenditure on in home care, this flexibility would provide access to child care for families where parents work unsociable hours (including medical workers and shift workers). It would also assist families who live in remote locations (particularly farmers). Further, it would assist families for whom standard child care facilities present difficulties (such as children with additional needs).

Greater competition between child care providers

22. At present, there are substantial regulatory barriers to establishing a child care facility and, in some parts of Australia, there is limited spare capacity in such facilities. Competition in some areas (both in price and level of service) may be limited, particularly given that the relevant market in which providers compete is highly localised.[27] If confronted with competition from in home care, child care facilities may improve their offerings. To the extent it is suggested that in home care carries greater risks than the provision of care at approved facilities, the Commonwealth ought to take comfort in the fact that parents are generally well placed to make decisions about the care of their children. That would include decisions obviating or managing risks which might eventuate at approved facilities.

It would be fair to allow deductions for child care

23. Assessing whether a particular policy reform is fair is an inherently subjective exercise. While providing tax deductibility would primarily (but not exclusively) benefit higher income earners, having regard to the overall circumstances, this can be regarded as fair:

    (a) Historically, the provision of tax deductions for child care expenses has been opposed on the basis that deductions are '*not an effective means of support for lower and middle income families*'.[28] However, this objection would fall away if the UNSW proposal were adopted, such that taxpayers could elect either to receive a subsidy or a tax deduction in a particular tax year.[29] Further, even though the deduction may tend to benefit high income earners, the same may be said of any deduction. This is simply an outcome of Australia's progressive tax system, such that deductions are more valuable in respect of income which would otherwise be taxed at a higher rate. There is no reason from a fairness perspective to distinguish between a deduction for child care and any other deduction. The only question is whether there should be a deduction.

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[26] There is a limited exception: the Commonwealth Government '*In Home Care Program*' provides funding for children to receive in home care if they meet specified criteria (the size of this program is capped at 3,200 places across Australia): see www.dese.gov.au/uncategorised/resources/home-care-national-guidelines.

[27] Productivity Commission, above n 22, vol 2, 380–1.

[28] Ibid, vol 1, 17.

[29] Dixon et al, above n 1, 20.

(b) The value of the proposed deduction is not dissimilar to the value of the subsidy: the maximum value of the $60,000 tax deduction under the UNSW proposal is $28,200 (assuming that both parents pay the top marginal rate of income tax). The value of the Commonwealth Government subsidy tapers according to income levels and is capped at $10,560 per child for households with incomes exceeding $189,390.[30] So for a household with three children, the value of the subsidy is (depending on income) approximately $31,680.

(c) It can reasonably be regarded as most unfair for a secondary income earner in a household to have an effective marginal tax rate approaching 100% (as to which see paragraph 19 above). No other participants in the formal economy are expected to work effectively for no remuneration. The proposed reform would remedy this unfairness.

(d) Given that the reform would provide particular benefits to secondary income earners in households (typically women, according to the Productivity Commission[31]), the reform would provide greater equality of opportunity for women. As the authors of the UNSW study observe:[32]

> *'To hold otherwise would simply be to uphold an unfair and outmoded view of family structure, and the role of Australian women and men at home and in the workforce. Those committed to equality should also be concerned to end discrimination on both economic and gender-based grounds.'*

(e) Taxpayers with employers who provide onsite child care facilities (including, for example, highly remunerated surgeons at hospitals) receive tax free child care (which, in economic terms, is equivalent to a deduction). This is provided by way of salary sacrifice arrangements.[33] It is not readily apparent why some taxpayers should receive such a benefit for the cost of child care, but others should not.

(f) At a conceptual level, it appears unfair to allow deductions for some expenses which may be viewed as preliminary to earning an income (such as self-education), but to deny deductions for child care, which is a real cost of working insofar as it is vital to enable a person to be available to work.[34]

It would be relatively simple to provide deductions for child care

24. It has been suggested that it may be complex for taxpayers to have a right of election;[35] the Henry Review said that *'[i]n terms of administration and compliance costs, it is likely to be simpler to provide*

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30 See www.servicesaustralia.gov.au/individuals/services/centrelink/child-care-subsidy/how-much-you-can-get/your-income-can-affect-it

31 Productivity Commission, above n 22, vol 1, 13.

32 Dixon et al, above n 1, 24.

33 *Fringe Benefits Tax Assessment Act 1986* (Cth) ss 47(2), 57A.

34 Dixon et al, above n 1, 24.

35 See, eg, Productivity Commission, above n 22, vol 2, 568.

[child care] assistance through a single mechanism in the transfer system, rather than through a tax deduction and transfer payment'.[36] But administration costs would be modest if, for example, taxpayers were required to choose not to receive subsidies before a financial year commenced and simply claimed the relevant deduction as part of preparing their tax returns.

The cost to the Budget of this reform is affordable

25. It is beyond our expertise to provide a costing for the tax deductibility of child care expenses. However, UNSW research suggests that the reform would have a cost to the Budget of, at most, $608 million p.a..[37] By comparison, the annual cost of the child care subsidy is approximately $8.3 billion.[38]

26. The UNSW research suggested that modest behavioural change (in the form of increased workforce participation and consequent tax revenue) means that '*there is a high likelihood that [the] … proposal would pay for itself (or more) from a fiscal standpoint*'.[39]

The reform may assist the economy in recovering from the COVID-19 pandemic

27. Improving the availability of child care may assist in recovering from the current pandemic. As noted above at paragraph 20, the reform may increase the participation rate. This may have two particular benefits at present. First, it may ameliorate difficulties caused by the decline in skilled migration following the closure of Australia's borders. Secondly, the greater availability of in home care may allow parents to take up opportunities to work from home. Such opportunities appear to have become more prevalent as part of the flexible work arrangements which emerged during the COVID-19 pandemic.

CONCLUSION

28. A judicial decision almost 50 years ago held that child care expenses were not incurred '*in*' earning income and were thus not tax deductible. There are strong policy justifications for legislative reform. Making such expenditure tax deductible would: increase workforce participation; promote competition between child care providers; be fair; be simple to implement; be affordable to the revenue; and a welcome response to relieve the harsh ramifications of the COVID-19 pandemic on Australian workers and the Australian economy more generally.

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[36] Commonwealth of Australia, *Australia's Future Tax System Review: Final Report (Henry Review)* (2010), vol 2, 586.

[37] Dixon et al, above n 1, 27.

[38] Commonwealth of Australia, *Department of Education and Training Budget Statement 2019-20*, 10.

[39] Dixon et al, above n 1, 27.