

The art of deduction

A small minority of people are spending large sums of money to aggressively minimise the tax they pay

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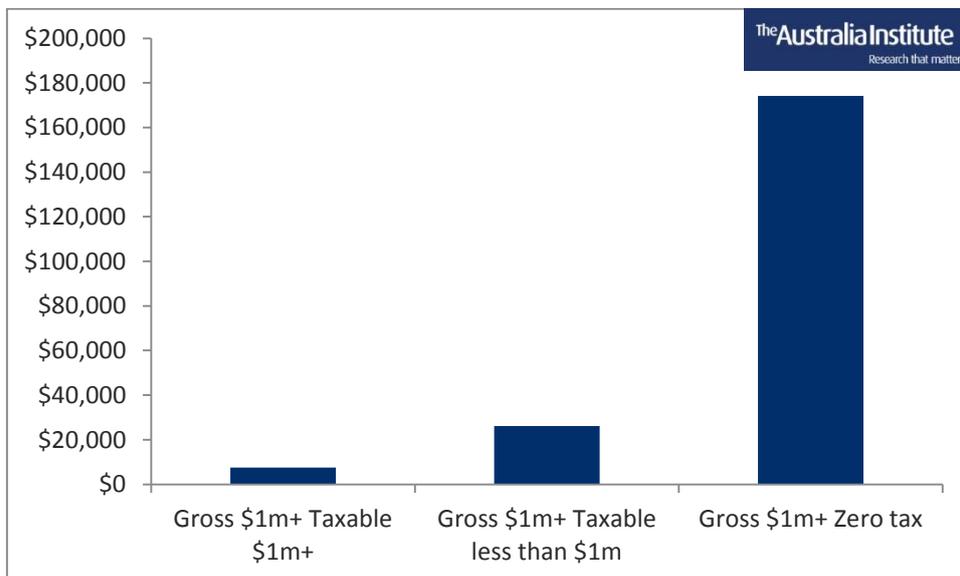
Introduction

The issue of tax concessions and tax loopholes has grown in prominence in recent years. Growing inequality has put the focus on those who seek to avoid paying their fair share in our progressive taxation system. These tax loopholes include excess franking credits that see mainly wealthy retirees who have paid no tax get a tax refund from the government.

The tax statistics give us an insight into how a small minority of people are spending very large sums of money in order to find and take advantage of tax loopholes. When we look at people's income before it is reduced by tax deductions we see that some people are able to substantially reduce the amount of tax they pay. But this comes at a large cost.

Looking just at people with gross incomes (incomes before tax deductions) of more than a million dollars we see that those with the largest deductions spend considerable more on managing their tax affairs. Figure 1 breaks those with gross incomes above a \$1 million into three groups. The first group is those who don't have sufficient deductions to reduce their taxable income below \$1 million and so their gross income and their taxable income are above \$1 million. The second group are those who did have sufficient deductions to reduce their taxable income below \$1 million, so their gross income is above \$1 million but their taxable income is below \$1 million. The third group is those that had enough deductions to reduce their taxable income below the tax-free threshold. This group had a gross income of more than \$1 million but paid no tax.

Figure 1 – Difference in average amount spent on managing tax affairs for very high income earners



Source: Australian Tax Office (2018) *Taxation Statistics 2015-16 – Individuals*, available at <https://data.gov.au/dataset/ds-dga-d170213c-4391-4d10-ac24-b0c11768da3f/details>

Those with a gross income of a million or more who did not get enough deductions to reduce their taxable income below \$1 million spent on average the least managing their tax affairs. They spent on average \$7,476. Those with a gross income of a million or more who did get sufficient deductions to reduce their taxable income to below \$1 million paid on average \$26,124, or three and half times more than the first group. Those with a gross income of \$1 million or more who got enough deductions to pay no tax at all paid on average \$174,201, or 23 times more than the first group.

Managing your tax affairs

The tax system is complex, and many Australians employ tax agents to help manage their tax affairs. These expenses are tax deductible, and taxation statistics show that six million Australians claimed about \$2.3 billion for managing their tax affairs in 2015-16 (the latest statistics available). The vast majority of these people are likely to be income earners paying their local tax agent to fill out their tax returns.

A small minority of people spend considerably more money managing their tax affairs to aggressively minimise the amount of tax they pay. Australia Institute research showed that in 2011-12 there were 75 individuals that earned more than a million dollars in gross income but found such large deductions that they reduced their

taxable income to below the tax-free threshold and so paid no tax.¹ These 75 individuals claimed an average deduction of \$860,000 for the cost of managing their tax affairs.

An industry that charges large fees to reduce client's taxable income is problematic not only because it undermines our progressive income tax system, but also because it is highly inefficient. Money spent avoiding tax could be more productively spent elsewhere and some of our brightest people spend their energies on unproductive work when they could be producing more socially desirable goods and services.

In response to these concerns, the Labor party has promised if elected to cap deductions for managing tax affairs to \$3,000.² This is designed to reduce the incentive for those with high gross incomes to spend large sums of money in order to aggressively reduce their taxable income.

Gross income refers to the total income an individual earns in a year. Taxable income is gross income minus all the individuals' deductions. Taxable income is the income the individual pays tax on.

What people spend managing their tax affairs

The average amount claimed for those with a taxable income between \$6,000 and \$250,000 was \$322.³ Those with a taxable income between \$6,000 and \$250,000 make up the vast majority of claims (96%).

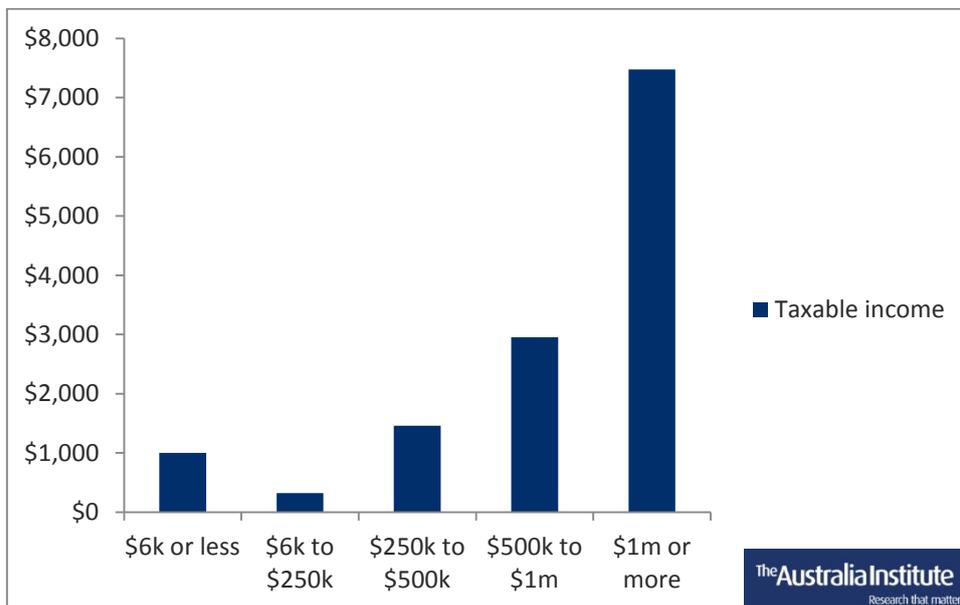
Those with taxable incomes of more than \$250,000 spend considerably more, on average, managing their tax affairs. Those with taxable incomes between \$250,000 and \$500,000 spend on average \$1,460 (four and a half times more than those with taxable incomes between \$6,000 and \$250,000). Those with taxable incomes between \$500,000 and \$1 million spend on average \$2,951 (nine times more) and those with taxable incomes of more than \$1 million spend \$7,476 (23 times more). The average amount spent managing their tax affairs by various taxable income groups is shown in Figure 2.

¹ Grudnoff M (2015) *Closing the tax loopholes: A Buffet rule for Australia*, The Australia Institute, April, available at <http://www.tai.org.au/sites/default/files/Bufett%20Rule%20Final_0.pdf>

² Janda M (2017) *Tax deductions for advice should be capped at \$3,000: Australia Institute*, ABC News, 22 May, available at <<https://www.abc.net.au/news/2017-05-22/tax-deductions-for-advice-should-be-capped/8546170>>

³ Australian Tax Office (2018) *Taxation Statistics 2015-16 – Individuals*, available at <<https://data.gov.au/dataset/ds-dga-d170213c-4391-4d10-ac24-b0c11768da3f/details>>

Figure 2 – Average amount spent managing tax affairs by various taxable income groups



Source: Australian Tax Office (2018) *Taxation Statistics 2015-16 – Individuals*, available at <https://data.gov.au/dataset/ds-dga-d170213c-4391-4d10-ac24-b0c11768da3f/details>

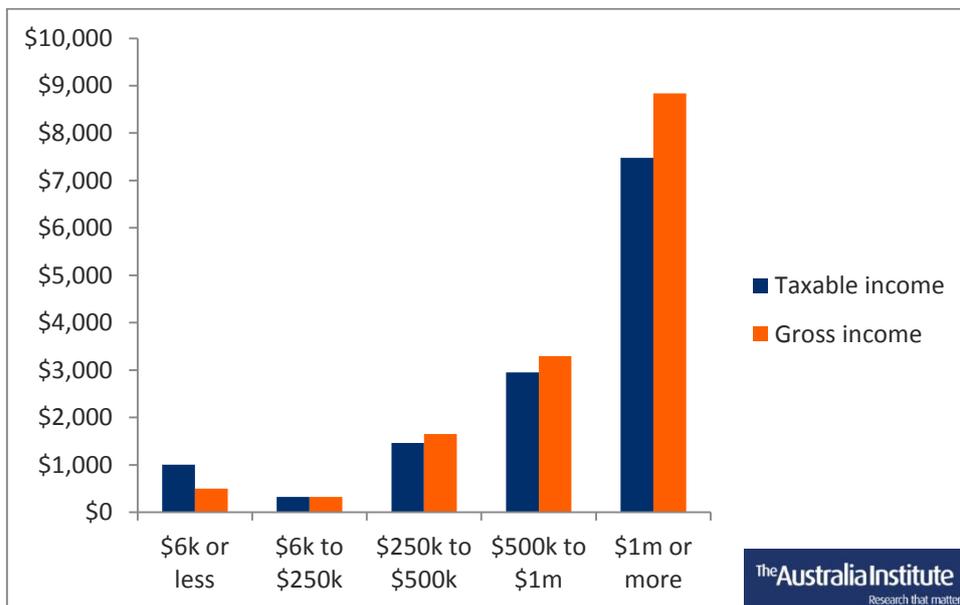
It might be expected that people with larger incomes pay more to manage their tax affairs. As someone's income rises there is an increasing chance they will have more complex financial arrangements. What is unusual is that people with a taxable income of less than \$6,000 spend on average \$1,003 managing their tax affairs, which is three times more than people with taxable incomes between \$6,000 and \$250,000 spend. If tax affairs get more complex as income grows, people with taxable incomes that are less than \$6,000 should spend relatively little managing their tax affairs.

One explanation as to why people with such low taxable incomes are spending on average \$1,003 managing their tax affairs could be that their gross incomes are much higher and they are spending considerable sums of money to aggressively minimise the amount of tax they pay.

Gross income

Another way to look at people's spending on managing their tax affairs is to look at it by gross income rather than taxable income. Gross income is income before deductions. When we compare gross income and taxable income by the average deduction for managing tax affairs, we see some differences. Figure 3 shows the difference between gross income and taxable income for various income groups by the average deduction for managing tax affairs.

Figure 3 – Difference in average deduction for managing tax affairs between gross and taxable income for various income groups



Source: Australian Tax Office (2018) *Taxation Statistics 2015-16 – Individuals*, available at <https://data.gov.au/dataset/ds-dga-d170213c-4391-4d10-ac24-b0c11768da3f/details>

For the vast majority of people, those earning between \$6,000 and \$250,000, the average amount is almost identical. People with higher gross incomes spend more on average than people on higher taxable incomes spend. This shows that people who spend more managing their tax affairs are successfully lowering their taxable income.

For the very bottom income group we see the reverse, where people with taxable incomes of less than \$6,000 spend considerable more than people with gross incomes of less than \$6,000 spend. This is also consistent with tax minimisation. People with a taxable income of less than \$6,000 that claim large amounts in deductions clearly have far higher gross incomes but have spent considerable sums reducing their taxable incomes to below \$6,000.

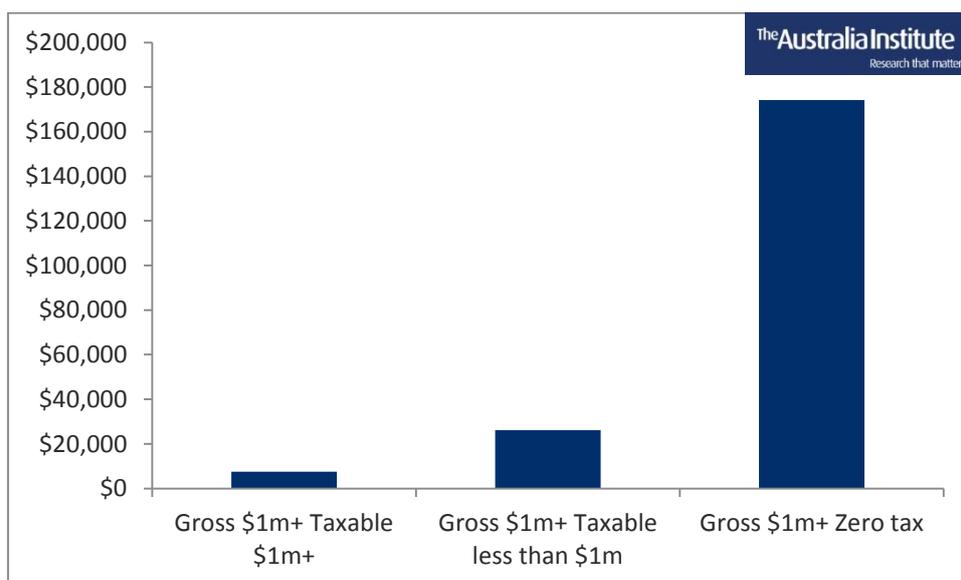
Very high income earners and the cost of managing tax affairs

At the very top of the income distribution there is an even larger disparity. If we look at just those with a gross income above \$1 million, we can split them into three groups. The first group is those with a gross income above \$1 million and a taxable income above \$1 million. The second group is those with a gross income of over \$1 million but a taxable income of less than \$1 million. The final group is those who earned above \$1 million but reduced their taxable income below the tax-free

threshold and therefore paid no tax. If the increase in the cost of managing tax affairs increases as income increases because those on high incomes have more complex tax affairs, then the average cost of managing tax affairs should be similar for all three groups.

As Figure 4 shows this is not the case. There are very large differences between each group that again grows as the size of the deductions grows.

Figure 4 – Difference in average amount spent on managing tax affairs for very high income earners



Source: Australian Tax Office (2018) *Taxation Statistics 2015-16 – Individuals*, available at <https://data.gov.au/dataset/ds-dga-d170213c-4391-4d10-ac24-b0c11768da3f/details>

Those with a gross income of a million or more who did not get enough deductions to reduce their taxable income below \$1 million spent on average the least managing their tax affairs. They spent on average \$7,476. Those with a gross income of a million or more who did get sufficient deductions to reduce their taxable income to below \$1 million paid on average \$26,124, or three and half times more than the first group. Those with a gross income of \$1 million or more who got enough deductions to pay no tax at all paid on average \$174,201, or 23 times more than the first group.

Conclusion

The taxation statistics show us that most people who pay for help managing their tax affairs spend a few hundred dollars, but there is a very small minority who are spending considerable sums of money to manage their tax affairs. These people are

more likely to have large gross incomes and some of them have been very successful in reducing the amount of tax they pay.

It is in the public good to discourage high income individuals from spending large sums of money to find tax loopholes. Doing so will not only make the taxation system fairer and more progressive, it will also discourage the largely unproductive industry focusing on finding and using complex tax loopholes.