

## **ANALYSIS OF REFORMS TO TAX LEGISLATION RELATING TO BUSINESS MEALS**

This report was prepared for the  
Australian Hotels Association and  
Restaurant & Catering Australia  
by Econtech Pty Ltd

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Econtech was commissioned by the Australian Hotels Association (AHA) and Restaurant & Catering Australia (R&CA) to analyse possible reforms to the current tax legislation relating to business meals. This Report sets out Econtech's findings. Econtech makes no representations to, and accepts no liability for, reliance on this work by any person or organisation other than AHA and R&CA. Any person, other than AHA and R&CA, who uses this work does so at their own risk and agrees to indemnify Econtech for any loss or damage arising from such use.

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## Executive Summary

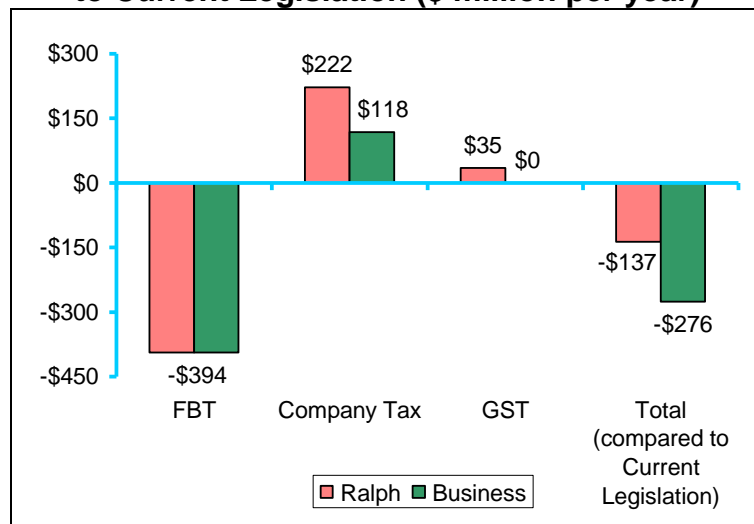
The current legislation governing the taxation of business meals is complex. The way the meal is taxed depends on the location in which a business meal is served and to whom it is served. It is also inconsistent in the way business related meals are treated. In line with this, three main problems have been identified with the current legislation.

1. It does not recognise that business meals are to some extent a necessary business expense.
2. Even for business meals that are more private in nature, it results in over-taxation for individuals who are not on the top marginal rate of personal income tax.
3. The legislation is complex and this leads to high compliance costs.

Two alternative policies specifically address these problems. The first is the “Ralph Review option”, which removes the FBT on meals provided to employees, but also removes their eligibility as company tax deductible expenses. The second is the “Business Expense option”, where business meals are treated like other business expenses. That is, these meals would be FBT free and fully company tax deductible.

The Ralph option provides a midpoint between the current over-taxation of business related employee meals (“Current Legislation”) and the option of treating all meals provided to employees as pure business expenses (“Business Expense option”).

**Chart 1**  
**Direct Budget Costs of Ralph Option and Business Expense Option compared to Current Legislation (\$ million per year)**



The Accommodation, Café and Restaurants industry is important as a major source of new jobs. Since November 1984, employment in this industry has risen almost 140 per cent, compared with a rise in total employment in all industries of just under 50 per cent. The Ralph and Business Expense options are expected to further boost employment in this industry by about 800 and 1,600 people or 0.3 and 0.6 per cent, respectively.

## 1. Introduction

The current legislation governing the taxation of business meals is complex. The way the meal is taxed depends on the location in which a business meal is served and to whom it is served. It is also inconsistent in the way business related meals are treated. In line with this, three main problems have been identified with the current legislation.

1. It does not recognise that business meals are to some extent a necessary business expense.
2. Even for business meals that are more private in nature, it results in over-taxation for individuals who are not on the top marginal rate of personal income tax.
3. The legislation is complex and this leads to high compliance costs.

Meals are often provided to employees for work-related reasons and, as such, should be treated as legitimate business expenses. This is confirmed by the fact that meals are not generally included as part of a salary package for employees (in contrast to other expenses that are classed as fringe benefits). However, in contrast to the treatment of most other business expenses (which are tax free and tax deductible), meals that are legitimate business expenses currently incur tax under the Fringe Benefit Tax (FBT) legislation.

This current taxation treatment of business meals distorts business decisions. Taxing business meals differently from other business inputs would encourage businesses away from purchasing business meals and towards other business inputs. These distortions mean that the economy would be using resources less efficiently than would have otherwise been the case. This has a negative impact on the economy, with meal preparation industries feeling the brunt of this distortion.

The second problem with the current legislation is that the over-taxation of meals leads to inequities between different employees. Where FBT is collected on meals provided to employees, this is supposed to make up for lost taxation income if the meal is private in nature. The FBT is designed to remove a possible tax loophole where an employer provides a (income tax free) meal, rather than additional (taxable) salary, to an employee. However, the FBT (at 48.5 per cent) on employer-provided meals results in over-taxation if the employee is not in the highest income tax bracket.

The final problem is that the current legislation relating to business meals is quite complex, with many different treatments for different types of business meals. The tax incurred on these meals depends on both the location in which the meal is served and to whom it is served. These complexities, in turn, lead to increased compliance costs associated with the increased detail required for record keeping.

Given these problems with the current legislation, the Australia Hotels Associations (AHA) and Restaurant & Catering Australia (R&CA) would like to see reforms to the tax legislation that particularly address the current over-taxation issue.

The AHA and R&CA have commissioned Econtech to analyse possible reforms to the current tax legislation relating to business meals. This report discusses five options for taxation of business meals (including the current legislation). Three of these options have been modelled.

Following this introduction, this report is structured as follows.

- Section 2 discusses the issues associated with the current legislation.
- Section 3 introduces four alternative legislative approaches to the taxation of business meals. It discusses how these alternatives address the problems with the current legislation.
- Section 4 presents the model findings for two alternative policy options.

While all care, skill and consideration has been used in the preparation of this report, the findings are based upon the strict instructions of AHA and R&CA, and are designed to be used only for the specific purpose set out below. If you believe that your instructions are different from those set out below, or you wish to use this work or information contained within it for another purpose, please contact us.

The specific purpose of the report is to provide AHA and R&CA with analysis of possible reforms to the current taxation of business meals.

The findings in this report are subject to unavoidable statistical variation. While all care has been taken to ensure that the statistical variation is kept to a minimum, care should be used whenever using this information. Should you require clarification of any material, please contact us.

## 2. Current Legislation

Under the current legislation governing the taxation of business meals, the way the meal is taxed depends on the location in which a business meal is served and to whom it is served. There are two main taxes that apply to business meals – fringe benefits tax (FBT) and company tax.

FBT is applied to fringe benefits that are provided to employees by employers. Under the current legislation, FBT applies to business meals that are provided to employees at a restaurant (other than in connection with business travel). The rate of FBT is 48.5 per cent.

Business meals may also be tax deductible expenses. Under the current legislation, business meals provided to employees at a restaurant are tax deductible expenses. In addition, the FBT itself is tax deductible. In contrast, where restaurant meals are provided to clients, FBT does not apply and the cost of the meal is not tax deductible.

While meals provided to employees at a restaurant (other than in connection with business travel) are tax deductible and subject to FBT, meals provided on the employee's work premises are not subject to FBT and are tax deductible. The focus of this report is on the situation where FBT does apply<sup>1</sup> i.e. business meals provided to employees at a restaurant (other than in connection with business travel).

Econtech has modelled the impact of the current legislation (FBT applicable and tax deductible) on the amount of tax paid for each \$1.00 spent on a business meal (exclusive of GST). This has been compared with the impacts if the same meal was treated more like a business expense (no FBT and tax deductible). Table 2.1 shows that an additional 80 cents in tax is being collected for every \$1.00 (exclusive of GST) spent on meals compared to the business expense scenario.

**Table 2.1**  
**Current Legislation compared to Treating Meals as a Business Expense**

	Current legislation
Individual's Income Tax Rate	
FBT rate	48.5%
Company Tax Rate	30%
GST rate	10%
FBT	\$1.14
company tax	-\$0.34
<b>Total Tax</b>	<b>\$0.80</b>

source: Econtech

<sup>1</sup> However, while this isn't examined in this report, it is important to note that the different treatment of in-house canteens and off-site meals means that businesses that can provide in-house meal benefits are advantaged by the fact that they have the capacity and tax incentives to provide canteens. Smaller businesses are less likely to be able to provide such facilities.

As discussed in the introduction, FBT applied to business meals (under the current legislation) has the following three problems:

- it does not recognise that such business meals are to some extent a necessary business expense;
- even for business meals that are more private in nature, it results in over-taxation for individuals who are not on the top marginal rate of personal income tax; and
- there are high compliance costs and complexity.

Each of these issues is now discussed in turn. Options to address these issues are then addressed in Section 3.

## 2.1 Over-Taxation of Some Employees

The first problem identified with the current legislation is that it may result in over-taxation even when applied to meals of a private nature. This occurs when the current FBT rate is applied to meals provided for employees who are not on the top marginal rate of personal income tax.

The current FBT rate is based on the top marginal tax rate of 48.5 per cent. Individuals earning less than \$70,000 in a fiscal year are subject to a marginal personal income tax rate that is less than 48.5 per cent. So, for meals provided to these employees, the amount of taxation collected through the FBT is higher than the loss in income tax that it is suppose to be offsetting.

ATO statistics show that in 2001-02 those on the top marginal tax rate made up almost 13 per cent of total taxpayers<sup>2</sup>. This means that FBT paid on meals provided to the remaining 87 per cent of employees is higher than it should be.

**Table 2.2**  
**Impact of Taxing the Cost of Meals in the hands of the Employee Compared to Treating Meals as a Business Expense**

	Current legislation	taxed in hands of employee (31.5c marginal tax rate)	taxed in hands of employee (48.5c marginal)
Individual's Income Tax Rate		31.5%	48.5%
FBT rate	48.5%		
Company Tax Rate	30%	30%	30%
GST rate	10%	10%	10%
individual income tax	\$0.00	\$0.51	\$1.04
GST	\$0.00	\$0.10	\$0.10
FBT	\$1.14	\$0.00	\$0.00
company tax	-\$0.34	-\$0.18	-\$0.34
Total Tax	\$0.80	\$0.42	\$0.80

Source: Econtech

<sup>2</sup> Australian Taxation Office, *Taxation Statistics 2001-02*, page 30.

Econtech has modelled the impact of removing the FBT on meals and, instead, taxing these meals in the hands of the employee. This way, the tax on the meals varies according to the marginal tax rate of individual employees.

For employees who are subject to a marginal tax rate of 48.5 cents in the dollar, the current legislation and the alternative option of taxing employees both show an additional 80 cents in tax being collected for every \$1.00 (exclusive of GST) spent on meals, compared to if the meal was treated purely as a business expense. These results are shown in the first and last column of Table 2.2.

However, for employees who are on a lower marginal tax rate (eg 31.5 cents in the dollar), the table shows that these employees would be paying a significantly lower amount of tax if the meal was taxed in the hands of the employee. By correcting for the over-taxation of these employees, the tax burden on these employees would be reduced by around 38 cents ( $80 - 42 = 38$ ). Thus the additional tax that would be collected for every \$1.00 (exclusive of GST) spent on meals, compared to if the meal was treated purely as a business expense, would fall from 80 cents to 42 cents for these employees.

This would be a more equitable way of taxing employee meals that are of a private nature.

## 2.2 Business Expense vs. Private Benefit

The second identified problem with the current legislation is that it does not recognise that many business meals provided to employees are a necessary business expense. According to the Australian Taxation Office (ATO), businesses can “generally claim an immediate deduction for expenses that are necessary for the everyday running of your business”<sup>3</sup>. This means that businesses expenses are generally subject to a tax deduction, at the company tax rate of 30 per cent.

Many business meals are also an expense that is necessary for the running of a business. Therefore, it follows that these business meals should also be treated as a tax deductible expense. However, as shown in Table 2.1, under the current legislation some business meals are tax deductible while others are non-deductible. For business meals that are a necessary business expense, these meals should be treated in the same way as other business expenses and therefore made tax deductible.

Econtech has modelled the impact of changing the current legislation so that all business meals provided to employees are treated as a business expense. This involves removing the FBT on meals and keeping them as fully tax deductible expense. This way, the tax on these meals is in line with the general taxation of other business expenses.

Table 2.1 showed that the current legislation (FBT applicable and tax deductible) resulted in an additional 80 cents in tax is being collected for every \$1.00 (exclusive of GST) spent on meals compared to this full business expense scenario (no FBT and tax deductible).

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<sup>3</sup> <http://www.ato.gov.au/businesses/content.asp?doc=/content/45586.htm>

### 2.3 High Compliance Costs and Complexity

The third identified problem with the current legislation is that there is high compliance costs associated with the current legislation. This is because the current legislation is complex. That is, there are different FBT and tax deductibility rules depending on whether the meal is provided to employees or clients, and where the meal is provided. Table 2.3 below shows that different situations attract different tax treatment.

Table 2.3 outlines the different taxation treatments associated with the different types of business meals.

**Table 2.3**  
**Tax Treatment for Taxable Employers of Providing Food and Drink**

Situation	FBT	Deduction
<i>Consumed on employer's premises by employees:</i>		
(1) At a social function	No	No
(2) At social function, in-house dining facility	No	No
(3) Not at a social function, in-house dining facility	No	Yes
(4) Morning/afternoon teas & light lunches	No	Yes
<i>Consumed off employer's premises by employees:</i>		
(5) At a social function or lunch including with associates	Yes	Yes
(6) By clients	No	No
<i>Consumed by employees while traveling:</i>		
(7) While travelling	No	Yes
(8) Employee travels with and dines with client	No	Yes

Source: Australian Taxation Office, Taxation Ruling TR 97/17

As shown in the table above, a meal provided to an employee on the employer's premises (say through an in-house canteen) is not subject to FBT, whereas a meal provided off-site (say at a restaurant) is subject to FBT.

Further complications arise through whether the meal is then tax deductible or not. If the meal is in-house and not a social function then it is deductible. In contrast, if it is in-house and at a social function then it is not deductible. Further, if it is off-site, regardless of whether it is classed as a social function or not, then it is deductible.

A more unified approach to taxing business meals would reduce complexity and the associated administration costs.

### 3. Alternative Policy Options

In this section, the problems identified with the current legislation are addressed by discussing a range of alternative policy options. Some of these alternative policies are then modelled in the following section.

Table 3.1 sets out four options for replacing the current legislation relating to the taxation of business meals. The table outlines the options in order from the highest tax revenue to the lowest tax revenue. Each of these policies is then discussed in separate subsections below.

**Table 3.1**  
**Options for taxation of employee business meals**

	FBT / income tax	tax deductible
Current legislation	FBT 48.5%	yes
Meal taxed in hands of employee (option 1)	taxed at employee's marginal income tax rate	yes
Ralph Review (option 2)	no FBT	no
Access Economics (option 3)	no FBT	50%
Business Expense Option (option 4)	no FBT	yes

Source: Econtech, ATO, Ralph Review, Access Economics

Table 3.2 summarises the impact of each policy in terms of tax collected for every \$1.00 (exclusive of GST) spent on employee meals.

**Table 3.2**  
**Options compared to Treating Meals as a Business Expense (tax per dollar)**

	employee marginal tax rate	
	31.5c	48.5c
Current legislation	\$0.80	\$0.80
Meal taxed in hands of employee	\$0.42	\$0.80
Ralph Review	\$0.40	\$0.40
Access Economics	\$0.20	\$0.20
Business Expense	\$0.00	\$0.00

As discussed in the previous section, the current legislation will generally result in the over-taxation of employee meals. This option would only be equitable if all the employee meals were not business related and were provided to employees who are currently on the highest (48.5 per cent) marginal tax bracket.

'Meals taxed in the hands of the employee' would also only be appropriate if these meals were private in nature, that is, if they were not business related.

The ‘Ralph Review’ and ‘Access Economics’ options both take into account that some employee meals will be private in nature and some will be business related.

The final option, the ‘Business Expense’ option, treats all employee meals as business expenses. This would be appropriate for business related meals, but inappropriate for meals that are private in nature.

The following sub-sections examine the arguments for and against each of these options.

### 3.1 Meals Taxed in hands of Employees

Under option 1 in Table 3.1, the FBT that is currently paid by employers would effectively be passed on to employees. This would involve categorising the meals provided to an employee as tax assessable income to that employee. This would address the current issue of over-taxation that arises because meals are taxed at the current high FBT rate. However, it does not address the problem that the current legislation effectively assumes all employee meals are private in nature.

By categorising the meals provided to an employee as tax assessable income to that employee, the tax collected would be based on the employee’s marginal rate of income tax. Under this alternative scenario, meals provided to employees earning less than \$70,000 per year would be subject to a tax rate of less than 48.5 per cent (current FBT rate).

The effect of this option was shown in Section 2.1. Employees who are on a lower marginal tax rate (eg 31.5 cents in the dollar) would be paying a significantly lower amount of tax if the meal was taxed in the hands of the employee, compared to under the current legislation. By correcting for the over-taxation of these employees, the tax burden on these employees would be reduced by around 38 cents ( $80 - 42 = 38$ ). Thus the additional tax that would be collected for every \$1.00 (exclusive of GST) spent on meals, compared to if the meal was treated purely as a business expense, would fall from 80 cents to 42 cents for these employees

To implement this type of policy, the taxation burden would be applied to employees rather than employers. So this alternative policy may deter restaurant dining. This is because employees are likely to resist spending their own money on restaurant meals that they see as being of a business nature.

### 3.2 Ralph Review

“A Tax System Redesigned” (also referred to as the Ralph Review report) suggests that the compliance cost of business meals being subject to FBT is high. Therefore, the Ralph Review suggested that business meals be FBT free, and non tax deductible. (Business meals are currently tax deductible for employers.)

In fact, the Ralph Review proposal addresses each of the three problems identified with the current legislation (as discussed in Section 2).

- The first identified problem with the current legislation is that there are high compliance costs associated with the current legislation. These high compliance costs are because the current legislation is complex. The Ralph scenario simplifies the taxation of business meals by adjusting the tax treatment of employee business meals so that it is identical to the current legislation for:
  - food and drink consumer on employer's premises by employees at social functions (number 1 in table 2.3);
  - in-house dining facilities (number 2 in table 2.3); and
  - business meals provided to clients (number 6 in table 2.3).

So, effectively, the Ralph Review proposal would mean that employee business meals would be treated the same way as client business meals. Hence, the legislation would be simplified and this should result in lower compliance costs.

- The second identified problem with the current legislation is that it does not recognise that business meals are to some extent a necessary business expense. This issue would be taken into account under the Ralph Review proposal because it would cease to treat employee business meals as a fringe benefit.

In contrast, Treasury continues to think of business meals as fringe benefits. This was the basis for not accepting the Ralph Review proposal when it was first raised. Specifically, Treasury has explained that, in the context of meals being classed as a fringe benefit, the government would consider it inequitable for some fringe benefits to be subject to FBT and not others. This is a reasonable argument for employer provided fringe benefits. However, the Treasury's reasoning for discarding the Ralph Review proposal is based on the misconception that all business meals provided to an employee are fringe benefits and not legitimate business expenses.

- The third identified problem with the current legislation is that it results in over-taxation for individuals who are not on the top marginal rate of personal income tax. The Ralph Review proposal would address this issue because there would be no FBT applied to business meals that are provided to employees.

The modelling results in Table 3.2 show that the tax burden of business meals suggested by the Ralph Review is in between the tax burden under the current legislation and under treating business meals as an ordinary business expense. Under the current legislation, tax on a business meal is 80 cents more than if the meal was treated as a business expense. By comparison, under the Ralph Review proposal, tax on a business meal would be 40 cents more than if it was treated as a business expense, but 40 cents less than under the current legislation (80 cents less 40 cents). More detailed results for this option are presented in section 4.

### 3.3 Access Economics Proposal

A report by Access Economics in 2001 recommended making business meals FBT free and 50 per cent tax deductible. This is another alternative to treating employee meals as a pure business expense or treating employee meals as a pure private expense.

In comparison to the Ralph option, this option does two things.

- i. It matches the Ralph suggestion to set employer provided meals to FBT free.
- ii. In contrast to the Ralph suggestion of also removing the tax deductibility of these meals, this option allows 50 per cent of the cost of these meals to be claimed as a deductible expense. This means that the tax deductibility rate on business meals under this proposal would essentially be 15 per cent (half of the company tax rate of 30 percent).

Obviously, a 50 per cent tax deduction would result in a cheaper meal than no (0 per cent) tax deduction (as applied to the above three scenarios).

Table 3.2 shows that by allowing businesses to continue to claim 50 per cent of the meal costs as a tax deductible business expense, this means the additional taxation burden is estimated at \$0.20 for every \$1.00 (exclusive of GST) spent on employee meals, compared to the full Business Expense option.

### 3.4 Business Expense Option

The final option examined in this section is where business meals are FBT free and fully tax deductible (“Business Expense option” in Table 3.1 and 3.2). In this case, employers would claim the cost of a business meal as a fully tax deductible expense (at the company tax rate of 30 per cent). This option would be the most appropriate option for employers that provide business-related meals to employees.

Table 3.2 shows that, by removing the FBT (48.5 per cent), employee meals become fully tax-free to business. Compared to the current legislation, this option shows that for every \$1.00 (exclusive of GST) spent on employee meals, the tax burden would be reduced from \$0.80 to \$0.00.

However, this policy option will not be appropriate for all employee meals, just for those that are business related. Employee meals of a private nature should be taxed under option 1 (taxed in the hands of the employee). By implementing a policy such as the business expense option, there is the possibility of a tax loophole where private meals are claimed as business meals. This concern led to the original introduction of the FBT.

#### 4. The Economic Effects of Two Alternative Policy Options

Section 3 explained that employee meals should be taxed in two ways:

1. Business related meals should be taxed under the Business Expense option; and
2. Private meals should be taxed in the hands of the employee.

However, this would only add to the third problem with the current legislation – that of complexity. One option, the Ralph Review option, provides a midpoint between the current over-taxation of business related employee meals and the option of treating all meals provided to employees as pure business expenses.

Given the considerations discussed in Section 3, Econtech has modelled three policies.

- The current legislation has been modelled as the “baseline scenario”.
- The “Ralph Review” and “Business Expenses” options have been modelled as alternative policy options.

To analyse the impact of changing the legislation, Econtech has then compared the results of the alternative scenarios with the current legislation. This means that the costs and benefits of reforming the current policy to one of these alternative policies are included in the modelling results.

- The Ralph Review proposal (as discussed in Section 3.2) is modelled because it addresses the three key problems with the current legislation (identified in Section 2).
- The Business Expenses Option (as discussed in Section 3.4) has also been modelled. It also addresses the problems identified with the current legislation.

To model the scenarios, Econtech has constructed a custom-built model to identify the direct impacts of each policy. In addition, Econtech has used its MM600+ model to identify the flow-through or indirect impacts on the rest of the economy.

The custom-built model is used to model the differences in tax collections and the cost of business meals under various policy options. Inputs into the model include alternative assumptions about the following variables.

- Rates of taxation in terms of FBT, GST, company tax and income tax.
- The extent to which meals are tax deductible.
- Who the tax burden from meal purchases is applied to. For example, you can choose between ‘companies paying FBT’ and ‘meals taxed in the hands of the employee’.

Results from the custom-built model were used in the option discussions in Section 3 and in estimating the direct budget impacts of each alternative policy.

MM600+ is used to model the economy-wide and industry-wide impact of taxation reforms. Econtech’s MM600+ model is a long-term computable general equilibrium (CGE) model of the Australian economy. MM600+ covers industry costs and prices as well as industry production and employment, and models market-clearing, long-term outcomes under optimising behaviour.

MM600+ distinguishes 672 products, making it six times more detailed than any comparable model. It achieves this high level of detail using unpublished input-output data obtained in an electronic format from the Australian Bureau of Statistics (ABS). So MM600+ provides highly detailed product results at the national level. These results cover production, employment, pricing and trade flows.

#### 4.1 Direct Impact on the Government Budget

This section examines the direct effect of the two alternative policy options on the Government budget. While the previous section examined the impacts for every \$1 worth of meals (excluding GST), this section puts these costs into perspective.

The first step in this analysis is to examine the contribution that FBT on meals for employees makes to total FBT collections. Detailed Table 4 in Chapter 12 of the Australian Taxation Office's (ATO's) 1998-99 Taxation Statistics publication<sup>4</sup> shows that the total FBT collected for meals/entertainment was around \$269 million for the 1999-00 income year.

To estimate the impact in the 2005-06 financial year, the \$269 million was inflated to 2005-06 dollars using an estimated change in nominal GDP over the same period, as shown in Table 4.1. This gave an estimated \$394 million in FBT collections on meals/entertainment for the 2005-06 financial year.

**Table 4.1**  
**Estimating FBT Collected and Total Amount Spent on Employee meals**

	\$ million
FBT collected on business meals in 1999-00 (1)	269
Nominal GDP in 1999-00	623,549
Estimated Nominal GDP in 2005-06 (2)	911,998
FBT collected on business meals in 2005-06	<b>394</b>
Meals/Entertainment FB Grossed-up amount	812
FBT Rate	48.5%
GST Rate	10%
FB Gross-up Rate	213%
total cost of business meals incl. GST	381
total cost of business meals excl. GST	<b>347</b>

(1) "business meals" refers to the "meals/entertainment" category in the ATO's Taxation Statistics publication. It does not include the separate "entertainment" category.

(2) Sourced from Econtech's MM2 forecasting tool. See <http://www.econtech.com.au> for more information.

Using the FBT Gross-up rule<sup>5</sup>, the total cost of meals/entertainment which will attract FBT in 2005-06 has been estimated at around \$347 million (excluding GST).

By holding constant the consumption of these meals/entertainment and applying the two different policy scenarios, we can then estimate the direct impact of each scenario on the Government budget.

<sup>4</sup> ATO, *Taxation Statistics 1998/99*, (<http://www.ato.gov.au/content/downloads/99fbt04.pdf>)

<sup>5</sup> Gross-up rate = (FBT rate + GST rate)/((1-FBT rate) x (1+GST rate) x FBT rate) = 2.13; and  
FBT = Gross-up rate x fringe benefits amounts x FBT rate = 2.13 x fringe benefits amounts x 48.5%.

Table 4.2 shows the total estimated direct effect on the Government budget. The two alternative policies will impact on the Government budget through changes in FBT, GST and company tax collections.

**Table 4.2**  
**Direct Effect on the Government Budget**

	Current	Ralph	Business
total cost of business meals excl. GST (\$m) (1)	\$347	\$347	\$347
<b>GST (\$m)</b>	<b>\$35</b>	<b>\$35</b>	<b>\$35</b>
total cost of business meals incl. GST (\$m)	\$381	\$381	\$381
<b>GST credit</b>	<b>\$35</b>		<b>\$35</b>
business meals FB Grossed-up amount	\$812	\$812	\$812
<b>FBT collected on business meals (\$m)</b>	<b>\$394</b>	<b>\$0</b>	<b>\$0</b>
tax deductible expense (\$m)	\$741	<b>\$0</b>	\$347
<b>company tax saving (\$m)</b>	<b>-\$222</b>	<b>\$0</b>	<b>-\$104</b>
<b>Total tax (\$m)</b>	<b>\$172</b>	<b>\$35</b>	<b>-\$104</b>
change in FBT collected on business meals (\$m)		-\$394	-\$394
change in company tax collected (\$m)		\$222	\$118
change in non deductible GST (\$m)		\$35	\$0
<b>change in tax compared to Current Legislation (\$m)</b>	<b>\$0</b>	<b>-\$137</b>	<b>-\$276</b>
<b>change in tax compared to Business Option (\$m)</b>	<b>\$276</b>	<b>\$139</b>	<b>\$0</b>

(1) "business meals" refers to the "meals/entertainment" category in the ATO's Taxation Statistics publication. It does not include the separate "entertainment" category.

Under both options, FBT is removed from employee meals. In our example above, this is estimated to cost the government \$394 million dollars in FBT taxation revenue in 2005-06.

Under the Ralph option, this loss in FBT revenue is somewhat offset by an increase in both company tax and GST collections. These are the result of removing the ability of businesses to continue to claim the cost of these meals (and the FBT on these meals) as a deductible expense for taxation purposes.

Without the ability to claim these expenses, this increases the company tax collected from businesses by \$222 million [ $30\% \times (\$347 + \$394)$ ]. Further, if an expense is non-deductible for taxation purposes, then a business is also not entitled to claim the GST as an input tax credit. Thus, this increases the GST collected by the Government by \$35 million ( $10\% \times \$347$ ).

Overall, the Ralph option is estimated to lead to a reduction in direct government tax receipts of \$137 million compared to under the current legislation ( $\$394 - \$222 - \$35$ ).

Taking this proposal one step further, the Business Expense option treats all employee meals as a business expense. As well as removing the FBT on these meals, this option allows

businesses to continue to claim the cost of these meals as a deductible expense for taxation purposes. This means that there is only a slight offsetting effect from an increase in company tax collections.

Under the current legislation, FBT costs are also tax deductible expenses. Thus, with the removal of FBT under the Business Expense option, this reduces the amount of business tax deductible expenses by the amount of the FBT. That is, the amount of expenditure that is tax deductible is now reduced by \$394 million. Without the ability to claim the FBT as an expense, this increases the company tax collected from businesses by \$118 million (30% x \$394).

Overall, the Business Expense option is estimated to lead to a reduction in direct government tax receipts of \$276 million (\$394 - \$118) compared to the current legislation. This is approximately twice the estimated reduction in tax receipts under the Ralph Review option.

This section only examines the direct effect of the two alternative options on the Government budget. The modelling in the following section examines the total effect. The analysis of the total effect makes the standard assumption that in the long-run the Government budget must be balanced. This is because a budget deficit is not sustainable in the long-run. This is discussed in more detail in the following section.

The last row in Table 4.2 shows that, if all employee meals are business related, then the current legislation is expected to collect \$276 million dollars in excess taxation in 2005-06, compared to if the legislation treated these meals as pure business expenses.

The Ralph option provides a midpoint between the current over-taxation of business related employee meals (“Current Legislation”) and the option of treating all meals provided to employees as pure business expenses (“Business Expense option”). The Ralph option shows the amount of over-taxation reducing to around half of the amount estimated under the Current Legislation.

## 4.2 Economy-wide Impacts of the Two Alternative Policy Scenarios

The economic modelling of the economy-wide effects of the two alternative policies was conducted using Econtech’s MM600+ model. MM600+ is a long-term CGE model of the Australian economy that models a long-run equilibrium. MM600+ is highly detailed, distinguishing 672 products produced by 108 industries. This makes it six times more detailed than any comparable model.

MM600+ has many features as follows:

- it fully incorporates the New Tax System (NTS) and models the GST treatment of each of its 672 products, and 24 other indirect taxes;
- it allows for substitution effects triggered by changes in the prices of goods & services. For example, MM600+ allows substitution between:
  - labour and capital;
  - different types of capital inputs such as motor vehicles, computers, buildings etc;
  - different forms of primary energy, including black coal, brown coal, and LPG;
  - local and export destinations for sales; and

- imports and local sources of supply of goods and services.
- it is set up to achieve budget neutrality in alternative ways. The default swing fiscal instrument, which is used in this report, is income tax, and the alternative swing fiscal instrument is GST;
- it provides valid measures of changes in consumer living standards based on compensating variations so that possible tax scenarios can be correctly evaluated in terms of the public interest.

MM600+ models a long-run equilibrium. In the long-run, economic agents optimise, all markets are in equilibrium, and assets and liabilities follow sustainable paths. Some of the key assumptions of particular interest for this analysis are as follows.

- *Budget balance*: in the long-run the government budget must be sustainable. This means that in MM600+ the government budget is assumed to be in balance in the long-run. Thus, in this analysis it is estimated that the Government will use labour tax receipts to finance this proposal.
- *Labour market equilibrium*: in the long-run the labour market is assumed to attain equilibrium, so that economic shocks, such as changes in production levels in one industry, have no lasting effect on total employment. Rather, only the distribution of total employment across industries is affected.

For more information on MM600+, download the model documentation from Econtech's web-site ([www.econtech.com.au](http://www.econtech.com.au)).

To examine the two alternative policy options, Econtech has modelled two scenarios.

- *Baseline Scenario* – this scenario models the Australian economy under the current tax arrangements. Specifically, the baseline scenario assumes that meals provided to employees attract FBT. The baseline is modelled in MM600+ by applying a production tax on 'meal preparation and presentation' equal to the amount of tax estimated in the last row of Table 4.2 (that is, \$276 million).
- *Ralph Review Scenario* – under this scenario, the removal of FBT on meals provided to employees is expected to boost demand in the Accommodation, Cafés & Restaurants industry. However, this will be somewhat offset by not allowing these meal costs to be claimed as a tax deductible expense. This option is modelled in MM600+ as a reduction in the production tax on 'meal preparation and presentation' that was applied under the baseline. This will reduce the costs in the industry, which will reduce the price of prepared meals, which, in turn, will boost demand for these services. It is assumed that the Government finances this proposal through labour income tax receipts.
- *Business Option Scenario* – under this scenario, demand in the Accommodation, Cafés & Restaurants industry is expected to be further boosted by allowing meals provided to employees to be both FBT free and tax deductible. This option is modelled in MM600+ by removing the production tax that was applied under the baseline.

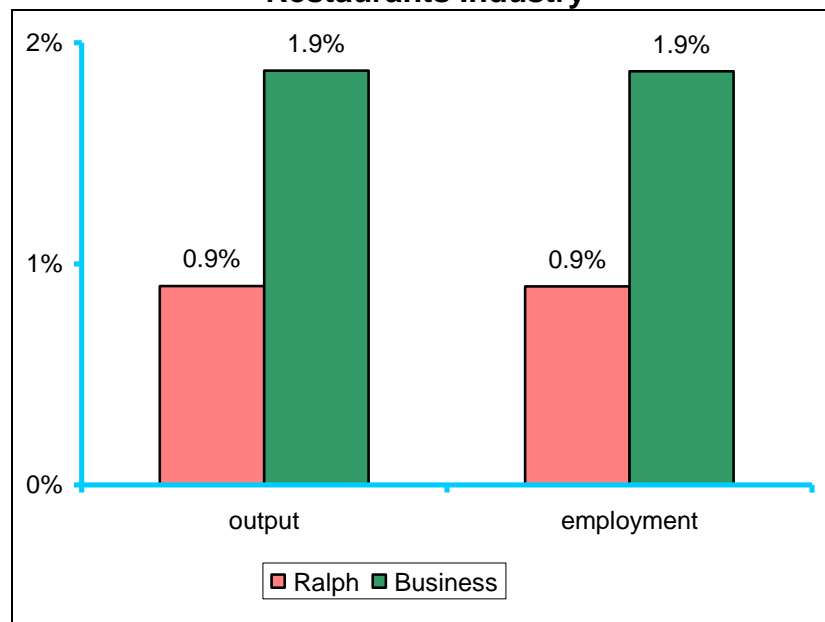
The two alternative scenarios are then compared to the Baseline Scenario to examine the impact of changing the legislation.

#### 4.2.1 Impact on the Accommodation, Cafés and Restaurants Industry

The two alternative taxation policies regarding employee meals are both expected to boost production and employment in the Accommodation, Cafés and Restaurants industry. This is because the changes in the tax treatment of these business meals will reduce the price of these meals to businesses, therefore stimulating additional demand for these products.

Chart 4.1 shows the estimated effect on employment and output in the Accommodation, Cafés & Restaurants industry.

**Chart 4.1**  
**Change in Employment and Output in the Accommodation, Cafés and Restaurants Industry**



The two alternative options are both expected to boost activity in the Accommodation, Cafés and Restaurants Industry. The chart above shows that output is expected to increase by 0.9 per cent under the Ralph option and 1.9 per cent under the Business option. Similarly, employment in this industry is expected to rise by around 0.9 per cent and 1.9 per cent under the Ralph and Business options, respectively.

#### 4.2.2 Industry-wide Production and Employment Effects

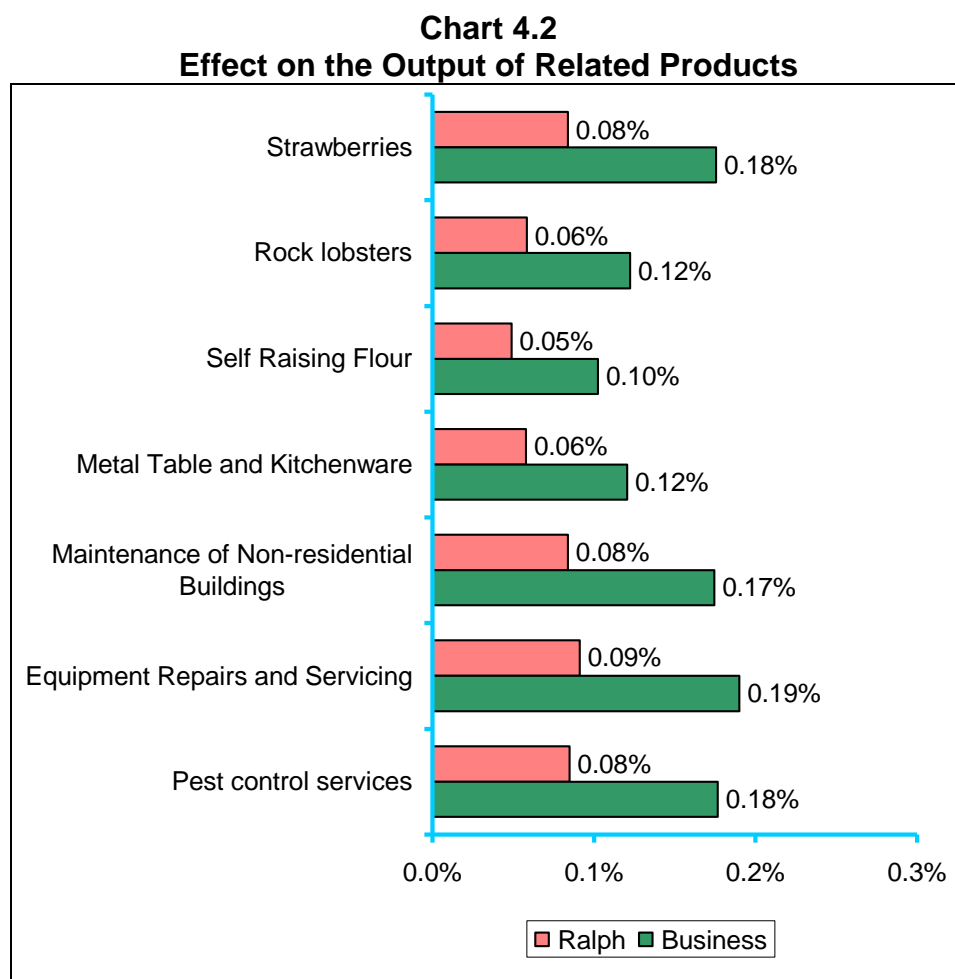
While the alternative options affect the distribution of employment across industries, the level of employment across the whole economy is not expected to change under either option.

As discussed at the beginning of Section 4.2, the modelling assumes labour market equilibrium. Changes in industry specific taxation policy, such as this, are therefore not assumed to create new jobs. National employment or unemployment remains unaffected because they both depend on the overall efficiency of the national labour market, which is assumed to be unaffected by this particular taxation policy. So, only the distribution of total employment between industries is affected.

It is important to analyse economic policies using a long-run model that generates sustainable outcomes. In contrast, short-term models, such as standard input-output models, often generate estimates of gains that are not sustainable, leaving an unjustifiably rosy impression of the policy proposal that is being modelled.

The Accommodation, Café and Restaurants industry is important as a major source of new jobs. Since November 1984, employment in this industry has risen almost 140 per cent, compared with a rise in total employment in all industries of just under 50 per cent. The Ralph and Business options are expected to further boost employment in this industry by about 800 and 1,600 people or 0.3 and 0.6 per cent, respectively.

Some of the broad industries that show a fall in employment and production have within them items whose production is boosted by the increase in café and restaurant activity. Examples of some of these related products are shown in the chart below.



The chart above gives some examples of the increase in the production of products that are supplied to the Accommodation, Cafés & Restaurants industry. These products include fresh fruit, seafood, other food products, tableware and some business services. Output in these product groups are expected to increase by between 0.05 per cent and 0.19 per cent.

### 4.2.3 Total Budget Effects

As shown in Section 4.1, the Ralph option and the Business Expense option are both expected to directly lead to a reduction in taxation revenue of \$137 and \$276 million dollars, respectively. In addition to these direct effects, there will also be indirect effects on the budget, resulting from the increase in the consumption of business meals and changes in production and employment across industries.

Chart 4.1 showed that the two alternative options are both expected to boost activity in the Accommodation, Cafés & Restaurants industry, with output expected to increase by 0.9 per cent under the Ralph option and 1.9 per cent under the Business option. This equates to an increase in consumption of meals of around \$64 million and \$133 million under the Ralph and Business options, respectively.

Table 4.4 shows this increase in the value of meals purchased and also the total estimated effects on the government budget. As discussed at the beginning of Section 4.2, the long-term modelling in MM600+ assumes that the government will use labour tax receipts to finance the alternative options. This is discussed in more detail below.

**Table 4.4**  
**Total Government Budget Effects (\$ million)**

	Ralph	Business
<b>Impact on Consumption of Meals</b>		
increase in business meals excl GST	64	133
increase in GST	6	13
increase in total cost of business meals incl. GST	70	146
<b>Change in Government Budget Receipts</b>		
Fringe Benefits Tax (as discussed in Section 4.1)	-394	-394
Company Tax (as discussed in Section 4.1)	222	78
<b>GST</b>		
<i>Business Meals (as discussed in Section 4.1)</i>	41	0
<i>Change in GST Collections - Other</i>	-49	-15
<b>Labour income tax and other tax revenue</b>		
<i>Accommodation, Cafés &amp; Restaurants industry</i>	154	170
<i>Other (to attain budget balance)</i>	25	161
<b>Total Budget Effects</b>	<b>0</b>	<b>0</b>

Table 4.4 shows that FBT receipts are expected to fall by around \$394 million as a direct result of the removal of FBT on business meals. This was discussed in Section 4.1 and is shown in the first row of the table above. The resulting additional expenditure on meals will not affect this change in FBT collections.

In contrast, company tax receipts are expected to rise under both scenarios as fewer costs are able to be claimed as tax deductible expenses, as discussed in Section 4.1. For the Ralph option, additional expenditure on meals will not affect the change in company tax collected, as these meals are non-deductible for taxation purposes.

For the Business Expense option, the increase in meal consumption will reduce the direct change in company tax by \$40 million – from \$118 million (as shown in Table 4.2) back to \$78 million. This is because businesses are spending additional money (\$133 million) on deductible expenses, thereby reducing their before tax profit. This in turn reduces their company tax liability ( $30\% \times \$133 = \$40$ ).

Further tax effects are expected through GST collections. As discussed in Section 4.1, under the Ralph proposal, the GST paid on a meal would not be eligible as an input tax credit. Thus the amount of GST receipts from business meals increase by around \$41 million under this option (\$35 million from Table 4.2 *plus* an additional \$6 million, as shown in the third row of Table 4.4).

On the other hand, GST collections are expected to be lower in other areas of the economy. It is expected that the proposal will lead to a substitution of spending towards meals and away from other goods and services across the economy. As a result, the GST collections on other goods and services are expected to be lower.

Finally, income tax collections are also expected to change under both options. With an increase in consumption of restaurant meals, employment in the Accommodation, Cafés & Restaurants industry is expected to increase, as discussed in Sections 4.2.1 and 4.2.2. Based on the average wage in this industry, income tax receipts from this boost in employment are expected to contribute an additional \$154 million in income tax revenue under the Ralph option and \$170 million under the Business option.

Further, as mentioned previously, it is assumed that the government budget is in balance in the long-run. This is because a budget deficit is not sustainable in the long-run. The net cost of the chosen option is expected to be financed by the Government through income tax receipts. Thus, the increase in other income tax revenue (row 14 in the table above) is expected to exactly offset the change in tax revenue from all other sources.