

McMillanShakespeareGroup

Second Submission to the Productivity Commission's Inquiry into Childcare and Early Childhood Learning

Response to Draft Report

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The McMillan Shakespeare Group of Companies

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Overview

This submission is the McMillan Shakespeare Group's (MMSG's) response to the Productivity Commission's Draft Report of its Inquiry into Childcare and Early Childhood Learning (the Draft Report).¹ It focuses on the following two aspects of the Draft Report:

- Draft Recommendation 12.1, being that the Australian Government should remove s 47(2) from the *Fringe Benefits Tax Assessment Act 1986*² (the FBT Act), but retain s 47(8).
- Draft Recommendation 10.1, being that the Australian Government should remove eligibility of Not-For-Profit (NFP) ECEC providers to Fringe Benefits Tax (FBT) exemptions and rebates. State and territory governments should remove eligibility of all NFP childcare providers to payroll tax exemptions.

The Commission's Inquiry represents a unique opportunity to recognise the potential for reforming particular FBT provisions to stimulate employers' involvement in childcare and thus improve workforce participation – one of the main aims of the Federal Government. Along with other sector participants, MMSG believes that this opportunity will be missed if Draft Recommendations 10.1 and 12.1 are progressed.

Executive summary

It is our view that:

- In relation to Draft Recommendation 12.1, we are concerned the Commission may have misunderstood both the interaction of FBT and salary sacrificing of childcare fees, and the reasons why s 47(2) is not being utilised to the extent envisaged by the Government.
- Section 47(2) should be retained, but without the "business premises" requirement and its inherent "control" test. This will allow multiple employers of any size or employee numbers to join together to provide professionally-managed childcare facilities for their employees and access the same FBT concessional treatment currently only enjoyed by Australia's largest companies.
- In recommending the retention of s 47(8) it is our view that the Commission has not adequately recognised the ongoing failure of that provision to provide any meaningful support to employers and their employees, and is mistaken in its belief that greater utilisation of the concession will increase workforce participation.

¹ Productivity Commission, *Childcare and Early Childhood Learning – Draft Report*, Canberra, July 2014.

² We note that Recommendation 12.1 of the Draft Report, at page 513, refers to the *Fringe Benefits Tax Act 1986*. However that Act does not contain a s 47(2) and hence we believe the Commission is instead referring to the *Fringe Benefits Tax Assessment Act 1986*.

- The economic justification for Draft Recommendation 10.1 does not exist and the rationale for the potential removal of the relevant FBT concessions is weak. We do not believe the Commission has given adequate weight to the reasons the Commission itself has identified for retention of the concessions, and has not sufficiently considered the adverse consequences of implementing the Recommendation.

This submission expands upon and provides support for each of the above views, including recommending certain specific amendments to both s 47(2) and s 47(8).

Submission in detail

Draft Recommendation 12.1 – Removal of FBT exemption for employer-provided childcare

A number of conceptual errors appear to have underpinned the Commission’s Draft Recommendation 12.1 that s 47(2) be “removed” from the FBT Act.³

Firstly, the Commission stated that s 47(2) exempts employer-provided childcare from the assessable income of their employees.⁴ This is not correct, and in fact the reverse is the case: a fringe benefit is generally exempt to the employee if the employer is subject to FBT on that benefit.⁵

Moreover, in advocating the removal of s 47(2), the Commission has not recognised that the provision focuses on expenditure of employers, not on expenditure of employees.⁶ Any employer contemplating placing reliance on s 47(2) is in fact contemplating making a substantial investment of capital and ongoing expenditure.

Importantly, increasing the scope for employers to utilise s 47(2) would encourage levels of investment that are not currently being contemplated. It is therefore, in our view, illogical to discourage this outcome on the basis that a positive tax expenditure would be experienced. We suggest it is akin to arguing that employers should be discouraged from relying on any tax concession because they increase positive tax expenditure. Tax concessions are there for a reason and in the case of s 47(2) it is to increase workforce participation by encouraging employers to be directly involved in providing childcare facilities for their employees.

The Commission also stated that employers can allow employees to salary sacrifice the cost of childcare when using employer-provided facilities but that this is mainly used by high income employees because salary sacrificing precludes access to the Child Care Benefit and the Child Care Rebate.⁷ However, we contend that this conclusion oversimplifies the option to salary sacrifice. In our experience, not all employers

³ Productivity Commission, fn 1, at page 513. For the purposes of this submission it has been assumed that the Commission believes s 47(2) should be repealed *only to the extent* that it currently applies to employer-provided childcare facilities, with the remainder of s 47(2) left in place.

⁴ Productivity Commission, fn 1, at page 512.

⁵ Section 23L, *Income Tax Assessment Act 1936*.

⁶ See, for example, Productivity Commission, fn 1, at page 513: “Any move to make the funding system less generous to higher income workers would be likely to lead to an expanded use of [s 47(2)].”

⁷ Productivity Commission, fn 1, at page 513.

providing childcare facilities seek full cost recovery from employees availing themselves of the benefit. Specifically, and as MMSG found from research conducted on its behalf by Sweeney Research and discussed in our original submission to the Commission, some employers do not seek any recovery of costs at all, some seek partial recovery of costs, and of those that do seek recovery of costs only some allow salary sacrificing.

In addition, parents have at times been disadvantaged because some employers have failed to carefully structure their childcare facility arrangements to fit within the complex FBT requirements, resulting in the Australian Taxation Office (ATO) treating particular salary-sacrificed fee arrangements as an expense payment fringe benefit which automatically disqualifies the employer from eligibility for exemption under s 47(2).⁸

The Commission acknowledged in its Draft Report that extending the current FBT exemption to any childcare provided or assisted by employers (as a number of organisations, including MMSG had called for) “would correct the inequity of the current system for some employees” but that “not all employers are likely to be able to provide, or purchase, childcare for their employees.”⁹ It is not suggested, however, that *all employers* would benefit from a widening of the scope of FBT exemption.

Instead, we firmly believe that extending the FBT exemption in the manner discussed below will significantly increase the number of employers *potentially* able to access an FBT exemption in respect of a decision made to assist employees with their childcare needs. As MMSG stated in its original submission to the Commission, Sweeney Research found that two-thirds of the 87% of surveyed employers not providing any form of childcare support attached importance to being unable to obtain FBT exemption as a barrier to providing childcare facilities.

Reforming s 47(2)

The major impediment any employer faces in being eligible for exemption under s 47(2) for expenditure incurred in providing childcare facilities is the requirement that the facility be on “business premises of the employer”.

Unfortunately, the “business premises” test is popularly understood as requiring that an employer’s childcare facility must be “on-site” in order to qualify for FBT exemption. This is not correct, and has never been the case, as was made clear by the Federal Court in 1998.¹⁰

Regardless of whether their childcare facility is “on-site” or “off-site”, many employers have failed to obtain FBT-exempt status because the ATO is not convinced they **control** the facility.¹¹ If an employer leases a childcare facility it has established “on-site” to a professional childcare operator, the employer has lost “control” of the facility and it is therefore no longer part of the business premises of the employer.

⁸ See, for example, Private Rulings Nos. 15730 and 64114.

⁹ Productivity Commission, fn 1, at page 513.

¹⁰ *Esso Australia Ltd v FCT* [1998] FCA 1253. Merkel J stated: “Common sense would dictate that in many instances basic requirements for child care facilities may be such that it is inappropriate for the facilities to be located upon the same premises where the other business operations of an employer are conducted.”

¹¹ See, for example, Private Rulings Nos. 26780, 40870, 54253, 58801, and 65809.

As MMSG stated in its original submission to the Commission, to be granted FBT-exempt status, the employer needs to ensure they comply with stringent requirements demonstrating control when establishing relevant management agreements and site rental agreements, as prescribed by the ATO in Taxation Ruling TR 2000/4, and supply to the ATO all relevant documents and contracts for the ATO's consideration of any private ruling seeking confirmation of FBT exemption status.¹²

It makes sense, in every way, for an employer to decide to engage a professional childcare operator to manage a childcare facility it establishes for the children of its employees. However, it does not in our view make sense that such an employer is unable to access the FBT exemption intended for employer-provided childcare because of that specific decision.

As the *Esso* case also highlighted, the business premises test in s 47(2) renders it impossible for multiple employers to join together to provide a childcare facility for each employer's employees, despite each employer not having the critical mass to provide such a facility on its own. To us this also does not make sense, particularly as it can be demonstrated that it effectively renders s 47(2) only available to the very largest companies in Australia, which is an arguably inequitable outcome.

We believe that rather than removing s 47(2), it should be reformed to:

- a) allow employers of any size and number to join together to provide childcare facilities for their respective employees;
- b) allow such facilities to be based anywhere convenient to the employer group providing them; and to
- c) allow such facilities to be managed and operated by professional third-party ECEC providers.

MMSG therefore submits that the following amendments to the FBT Act be recommended:

- New section 57B be inserted in Division 13 of the FBT Act to provide that

"57B Exempt benefits – childcare benefits

Where a benefit provided to a current employee in respect of his or her employment consists of

- (a) the care of a child or children of the employee in a childcare facility established by the employer, or by the employer jointly with other non-associated employers; or
 - (b) a payment to secure a place of a child or children of the employee in a childcare facility,
- the benefit is an exempt benefit."

- Subsection 47(2) be amended so as to only apply to the benefit of a recreational facility.

¹² Commissioner of Taxation, *Taxation Ruling TR 2000/4: Fringe benefits tax: meaning of 'business premises'*, Canberra, 1 March 2000, See, for example, paras 55-60 and 70.

The above suggested amendment is absent the “business premises” test. It also enables any number of like-minded employers in the same locale to join together in providing a childcare facility.

The purpose of moving the current exemption from s 47(2) to Division 13 of the FBT Act would be to obviate the artificiality of creating a distinction between current exempt employer-provided childcare combined with salary-sacrificed fee arrangements and the current taxable nature of an employer reimbursing or paying an employee’s childcare fees in respect of a third party childcare facility.

The purpose of paragraph (b) above would be to remove the need to retain the ineffective s 47(8), as discussed below.

Subsection 47(8)

Whilst MMSG supports the Commission’s Draft Recommendation 12.1 in relation to the retention of s 47(8), we submit that the Commission appears to have placed too much reliance on the provision as a major means for employers to support their employees’ access to ECEC services.

As we stated in our original submission to the Commission, the House of Representatives Standing Committee on Family and Human Services previously concluded that employers were not using the exemption because it was poorly understood and complicated, as evidenced by a survey conducted of 599 employers which found that not a single employer had taken advantage of it.¹³ Furthermore, the Commonwealth Treasury has been unable to quantify any amount of tax expenditure relating to s 47(8).¹⁴

Even if more employers were aware of s 47(8) and understood its requirements, it is a very difficult concession for any employer to come within its terms in practice. As the ATO itself has acknowledged, it is “a difficult process”.¹⁵

Conceivably, s 47(8) could be amended to enable greater reliance to be placed on it, as we have suggested above. However, in our view it is likely to remain a non-persuasive means of encouraging workforce participation and would do nothing to increase localised supply of ECEC services within workforce areas or to encourage sustained employer involvement in assisting employees with their childcare needs.

Draft Recommendation 10.1 – Removal of FBT concessions for NFP ECEC providers

¹³ Parliament of the Commonwealth of Australia, House of Representatives Standing Committee on Family and Human Services, *Balancing Work and Family – Report on the Inquiry into balancing work and family*, Canberra, December 2016, at p 83, para [3.48].

¹⁴ The Treasury, *Tax Expenditures Statement 2013*, January 2014, Canberra, at page 124.

¹⁵ Commissioner of Taxation, *ATO Interpretative Decision ATO ID 2012/58: Fringe Benefits Tax: Exempt Benefits: priority of access to a child care service*, Canberra, 20 June 2012. As per subparas 47(8)(a)(v)-(viii) of the FBT Act, the employer has to determine that the relevant childcare service had a certificate of approval issued pursuant to s 195 of the *A New Tax System (Family Assistance) (Administration) Act 1999* that covered both the time of the employer’s contribution and the time that priority of access was granted to the employee’s child.

The Commission concluded in its Draft Report that the FBT exemptions and rebates available to NFP ECEC providers had created an uneven playing field across all ECEC providers, and therefore should be removed.¹⁶

As the following discussion demonstrates, it is our view that the Commission's conclusion is erroneous.

Use of FBT concessions by NFP operators is not evident

The Commission's own "confidential evidence" indicates the value of the FBT concessions available to NFP ECEC providers is roughly 1.25% of revenue,¹⁷ but no evidence has been produced of the extent that value has translated to actual Tax Expenditure within the ECEC market. If utilisation of the concessions is not widespread, which we believe is the case, then in our opinion the "playing field" cannot be said to be materially impacted in any material manner.

The Commission also stated that the FBT concessions available to NFP ECEC providers allow them to employ staff at below market rates.¹⁸ MMSG has discussed this claim with a number of NFP and For-Profit ECEC providers and has reviewed a number of recent Enterprise Agreements registered by Fair Work Australia, and no disparities in wage rates are evident between NFP ECEC employers and For-Profit ECEC employers. Moreover, the industry union, United Voice, represents employees of both types of employers in enterprise bargaining and negotiates identical award rates. We could thus find no evidence to support the Commission's claim.

Market share of childcare services of NFPs is steadily declining

The ECEC market has experienced a gradually increasing presence of For-Profit operators. As the Commission itself noted in its Draft Report, For-Profit market share of long day care, for example, increased from 48% in 1991 to 70% in 2012, with a six-fold increase in the number of places at For-Profit centres.¹⁹ Such domination by For-Profits has occurred during a period in which there have been no changes to either the FBT concessions available to NFP ECEC providers or, to our knowledge, the level of their utilisation.

Profit margins of NFP providers are negligible

For the year ended 30 June 2013, the largest NFP ECEC provider, Goodstart Early Learning, derived an EBIT margin of only 1.2% (2012: 2.3%).²⁰ This appears to not be an exception in the NFP ECEC sector. KU Children's Services, for example, is the largest non-government NFP ECEC provider in NSW and operates on EBIT margins consistently below 3%.²¹

The exceptionally low profit margins of NFP ECEC providers are in stark contrast to those experienced by For-Profit ECEC providers. For example, G8 Education, the largest For-

¹⁶ Productivity Commission, fn 1, at page 423.

¹⁷ Productivity Commission, fn 1, at page 463.

¹⁸ Productivity Commission, fn 1, at page 463.

¹⁹ Productivity Commission, fn 1, at page 441.

²⁰ Arna Richardson, *Child Care Services in Australia*, IBISWorld Industry Report Q8710, June 2014, at page 23.

²¹ Arna Richardson, fn 20, at page 25.

Profit ECEC provider, derived an EBIT margin of 17.9% in 2013 (2012: 16.3%).²² This large disparity in profit margins evidences a skewed playing field in favour of For-Profits, not the reverse. It is not evidence of NFP providers being less efficient, it is simply a function of differing aims and business models.

Other competitive factors are at play

Aside from any competitive influence that FBT concessions may have in the ECEC market, which is disputed, there are other factors in play which we believe the Commission has either discounted or been unable to adequately quantify. It is submitted that such factors warrant further examination and/or quantification before conclusions be reached about the targeted FBT concessions for NFP ECEC providers. These include:

- a) the degree of price competition in the ECEC market – the Commission was unable to quantify this factor in its Draft Report²³; and
- b) the degree to which service quality is improved by competition – again, the Commission was not able reach any conclusions in its Draft Report.²⁴

Finally, it is our view that were the ECEC market to be a level playing field, barriers to entry and expansion would be the same for NFP operators as they would be for For-Profit operators. They are not. For example, as the Commission itself stated in 2010, NFPs other than large organisations “fail the lending criteria of conventional lenders and, as a result, often find accessing capital to develop or expand their activities difficult.”²⁵

Given the capital-intensive nature of the ECEC sector, access to capital (or more correctly, the barriers to access to capital) is, in our opinion, a far more dominant issue for competitive neutrality within the sector than the questionable impact of FBT concessions for NFP ECEC providers.

Summary

The Commission was tasked to make recommendations, among other things, on the contribution that access to childcare can make to increased participation in the workforce. Removing s 47(2) of the FBT Act to the extent it applies to childcare would instead have the immediate effect of disenfranchising those employers currently providing childcare facilities. Section 47(8) will never meet the Government’s aims to increase workforce participation.

MMSG strongly believes that s 47(2) can be reformed to provide a real incentive to employers, above and beyond mere ‘Employer of Choice’ benefits, to invest capital and ongoing expenditure in assisting employees with childcare, and thus make a substantive and on-going contribution to increasing workforce participation. To this end, we have identified several conceptual issues with the Commission’s understanding of the current

²² Arna Richardson, fn 20, at page 20.

²³ Productivity Commission, fn 1, at page 431.

²⁴ Productivity Commission, fn 1, at page 435.

²⁵ Productivity Commission, *Contribution of the Not-for-Profit Sector*, Research Report, January 2010, Canberra, at page 185.

relationship between FBT and employer involvement with childcare, and we have formulated a specific means by which s 47(2) can be reformed.

MMSG also submits that the FBT exemptions and rebates available to NFP ECEC providers have not created an uneven playing field across all ECEC providers, and we have provided a number of reasons evidencing that fact. There are a large number of ECEC providers in the Australian market, varying in size from single centres to many, with no single provider dominating the market. This large and diverse profile is one shared between NFP providers and For-Profit providers, yet their underlying motives are different. NFP providers desire to serve the community whereas For-Profits desire to maximise shareholders' returns. Combined with completely different taxation statuses, their business models are fundamentally divergent, their respective ability to raise capital is different, and their margins are different. The actual impact of the FBT concessions available to NFP providers on those elements is currently indeterminate and cannot conceivably be significant if "a level playing field" is sought to be achieved.

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