

3: Individuals

Overview

This chapter gives an overview of Australia's individuals income tax system and issues arising in the current system that may present scope for reform.

Key points

- Individuals income tax is the single most important source of government revenue and has consistently raised around half of the Australian Government's tax receipts since the 1970s. It continues to be a stable and predictable source of revenue to this day.
- Individuals income tax thresholds are not automatically indexed to inflation. This results in bracket creep, which increases the reliance on individuals income tax over time. Unchecked bracket creep can also exacerbate any issues inherent in the individuals income tax system.
- For many people, individuals income tax does not significantly alter their workforce participation. However, it can be more distorting for particular groups of taxpayers, such as low-income earners or the second income earner in a family, or high-income earners with the ability to plan their tax affairs.
- Australia's individuals income tax regime is very progressive compared to other countries. We have relatively low average rates of tax at low levels of income, but we have relatively high marginal tax rates at medium and high levels of income.

3.1: Overview of the individuals income tax system

What is individuals income tax?

Individuals income tax refers to the tax that people pay on their personal income, less any expenses (called deductions) incurred in generating that income. Examples of personal income include salary and wages; rent, interest, or net capital gains from investments; distributions from a trust or partnership; and returns generated from carrying on an unincorporated business.

Deductions for costs incurred in producing assessable income recognise that different people incur different costs in producing income. Examples of such costs include: work-related expenses (such as purchasing and cleaning uniforms, self-education expenses and motor vehicle expenses); interest repayments on loans used to purchase investments; and expenses incurred in carrying on a business.

Income that is subject to tax in the individuals income tax system is called 'taxable income'. The amount of tax that people pay on their taxable income is primarily determined by the schedule of marginal rates and thresholds. It can also be either increased by levies or reduced by any concessions or offsets for which a person is either liable or eligible.

Individuals may also receive non-cash remuneration from employers, called 'fringe benefits', such as the use of a car or accommodation, as part of an employment relationship. These are taxed in the fringe benefits tax (FBT) system, rather than in the individuals income tax system. While FBT is levied on and paid by employers, it relates to the non-cash payments received by employees. FBT is discussed separately under 'overview of the fringe benefits tax system' below.

Rates and thresholds

Australia's individuals income tax schedule is progressive, with a high tax-free threshold followed by increasing tax rates at subsequent thresholds (see Table 3.1). The rate specified at each tax bracket is the 'marginal' tax rate, which is the amount of tax payable on a taxpayer's next dollar of taxable income, not the 'average' tax rate on that person's entire taxable income (see Chart 3.1).

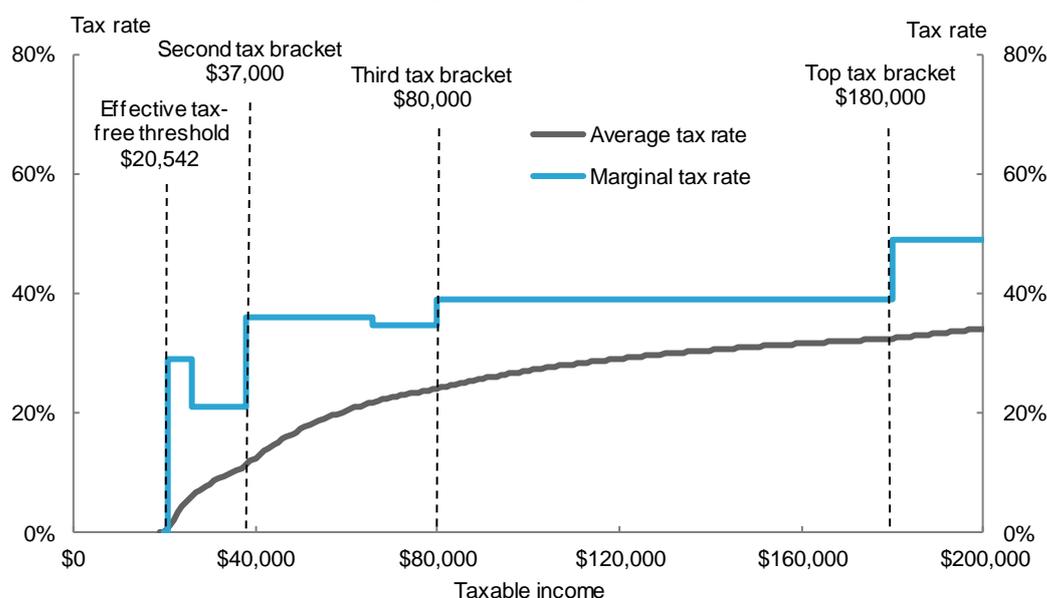
Table 3.1 Schedule of marginal rates and thresholds, 2014-15

Taxable income	Tax on this income
\$0—\$18,200	Nil
\$18,201—\$37,000	19 cents for each \$1 over \$18,200
\$37,001—\$80,000	\$3,572 plus 32.5 cents for each \$1 over \$37,000
\$80,001—\$180,000	\$17,547 plus 37 cents for each \$1 over \$80,000
\$180,001 and over	\$54,547 plus 45 cents for each \$1 over \$180,000
<p>The maximum low-income tax offset (LITO) of \$445 is available for individuals with income below \$37,000. These people have an 'effective tax-free threshold' of \$20,542.</p> <p>The Medicare levy of 2 per cent also separately applies to most taxpayers' total taxable income.</p> <p>The Temporary Budget Repair Levy is payable at a rate of 2 per cent on taxable income over \$180,000 between the years 2014-15 and 2016-17.</p>	

Someone with taxable income of \$85,000 would face a marginal tax rate of 39 cents on their next dollar of income (the statutory rate of 37 per cent and the Medicare levy of 2 per cent). But their average tax rate would be much lower: 24.8 per cent, or \$19,397 in tax and \$1,700 in Medicare levy as a proportion of their taxable income of \$85,000.

The tax thresholds are not indexed, which means that they do not automatically keep pace with either inflation or wage growth. As discussed in Chapter 2, this leads to bracket creep, which erodes the value of tax cuts and reduces the progressivity of the tax system over time. To address this, governments need to periodically give further tax cuts to maintain the rewards for effort, which in turn keep from discouraging workforce participation or from encouraging tax planning and structuring. These considerations are discussed further in section 3.3 of this chapter.

Chart 3.1 Average and marginal tax rates, 2014-15



Notes: The rates shown are for a single person with no dependants who does not receive any Australian Government transfer payments. Marginal tax rates take account of the statutory rates shown in Table 3.1, as well as the Medicare levy of 2 per cent, the Temporary Budget Repair Levy (an additional 2 per cent on taxable income in excess of \$180,000 per year) and the LITO. The LITO brings the effective tax-free threshold to \$20,542. The 10 percentage point increase in marginal tax rates between \$20,542 and \$25,677 is due to the phase-out of the Medicare levy low-income concession. The 1.5 percentage point increase in marginal tax rates between \$37,001 and \$66,667 is due to the phase-out of the LITO.

Concessions

Concessions refer to the treatment of income that may be exempt from tax or taxed at less than full marginal rates. Australia has a broad individuals income tax base, with relatively limited concessions on labour income, although there is concessional treatment for income from saving (such as superannuation or capital gains — Chapter 4) and income from carrying on a business (such as capital gains tax concessions targeted to small business — Chapter 6).

Levies

In the Australian tax system levies are generally linked to funding a particular government expenditure. Temporary levies are sometimes imposed to raise revenue to meet a particular need. The main permanent levy in the individuals income tax system is the Medicare levy. It is similar to the social security contributions used in other countries because it is applied at a flat rate on a person's entire taxable income. Low-income individuals and households may pay a reduced amount of the Medicare levy or no Medicare levy at all. Singles with no

dependants do not pay any Medicare levy until their taxable income exceeds \$20,542.²⁴ Above this threshold, the concession is withdrawn at a marginal rate of 10 per cent (shown in Chart 3.1) until the Medicare levy is fully phased in by \$25,677. This ensures that lower-income earners do not face the full rate of Medicare levy suddenly when they reach the threshold, but that it is gradually phased in.

Although the Medicare levy was directly tied to the introduction of Medicare in 1984, it is not formally hypothecated to the costs of the Medicare scheme. In 2013–14 it raised around \$10.3 billion in revenue.²⁵ This only partially offsets total Australian Government expenditure on health, which for 2013-14 was \$64 billion,²⁶ or Australian Government expenditure on Medicare services, which for 2013-14 was \$19.3 billion.²⁷ The rate of the Medicare levy was recently increased by half a percentage point to 2 per cent from 1 July 2014 to help fund the introduction of the National Disability Insurance Scheme (NDIS). All additional revenue from the increase in the Medicare levy for ten years will go directly toward funding the NDIS.

Offsets

Tax offsets are concessions that reduce a person's tax liability. If someone does not have a tax liability (for example, because their taxable income falls below the tax-free threshold), then they generally cannot benefit from offsets.

The main tax offset that is a structural part of the individuals income tax system is the low-income tax offset (LITO). The LITO is available in full for individuals with taxable income up to \$37,000, then withdrawn gradually after that. Combined with the \$18,200 tax-free threshold, people do not begin to pay tax until their taxable income exceeds \$20,542 (their *effective* tax-free threshold). The benefit from the LITO is fully withdrawn for people with taxable income in excess of \$66,667.

The number of tax offsets in the individuals income tax system has been reduced over time. Of those that remain, the seniors and pensioners tax offset (SAPTO) and the beneficiaries tax offset (BENTO) exist in order to ensure that recipients of Australian Government pensions and allowances respectively do not pay any tax on those pensions or allowances. Other tax offsets continue to be available in order to deliver assistance to particular groups of taxpayers, such as: the zone tax offset; the net medical expenses tax offset; the dependent (invalid and carer) tax offset; and the employment termination payments tax offset.

24 Couples, families with children, senior Australians and recipients of Australian Government pensions and benefits may have higher amounts of taxable income before they begin to pay the Medicare levy. In addition, certain groups are exempt from paying the Medicare levy, for example blind pensioners and defence force personnel.

25 Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra.

26 Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra.

27 Australian Government 2014, *2014-15 Budget: Budget Strategy and Outlook Paper No. 1*, Australian Government, Canberra.

How important is individuals income tax as a revenue source for government?

Individuals income tax is the single largest Australian Government revenue source and has consistently raised around half of the Australian Government's tax receipts since the 1970s. As employment and wage growth tends to be relatively steady, individuals income tax is a stable revenue source. To address bracket creep and maintain the rewards for effort, governments over recent decades have generally lowered rates or raised thresholds to deliver tax cuts from time to time, keeping the proportion of revenue raised from individuals income tax relatively stable.

Who pays individuals income tax?

The unit of assessment for individuals income taxation in Australia is the individual. This means the progressivity of the individuals income tax system applies to taxable income in the individual's hands, but not necessarily to a household's taxable income (Box 3.1). This is different from the objectives of the transfer system where assistance is generally targeted based on the needs of a household, although certain tax concessions mirror assistance provided through the transfer system and adopt similar principles for targeting assistance.²⁸

12.6 million Australians lodged an income tax return for the 2011-12 income year, of which 9.8 million Australians were net taxpayers.^{29,30} The higher number of people lodging tax returns is due to a range of factors, including having too much tax withheld during the year (and receiving a refund upon assessment of the tax return); lodging a tax return to claim deductions that reduce taxable incomes or offsets that reduce tax liabilities; or carrying forward losses from earlier tax years that reduce taxable incomes.

Australian residents pay tax on their 'world income' which includes income sourced in Australia, as well as foreign-sourced income (generally less a credit for any tax paid in the foreign country). Non-residents are generally subject to Australian tax on their Australian source income.³¹ Given increased globalisation and digitisation, concepts of 'source' or 'residency status' may not always be straightforward, particularly for taxpayers with complex income arrangements, or taxpayers who cross borders frequently.

28 These include the Medicare levy low-income thresholds, the seniors and pensioners tax offset, the net medical expenses tax offset, and the dependent (invalid and carer) tax offset.

29 Australian Taxation Office (ATO) 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

30 'Net tax paid' does not take account of any transfer payments a person may be eligible for, such as Family Tax Benefit, Child Care Benefit.

31 This treatment applies in the absence of a tax treaty between Australia and another country. Australia currently has tax treaties with over 40 countries, which are intended to prevent double taxation and minimise tax evasion.

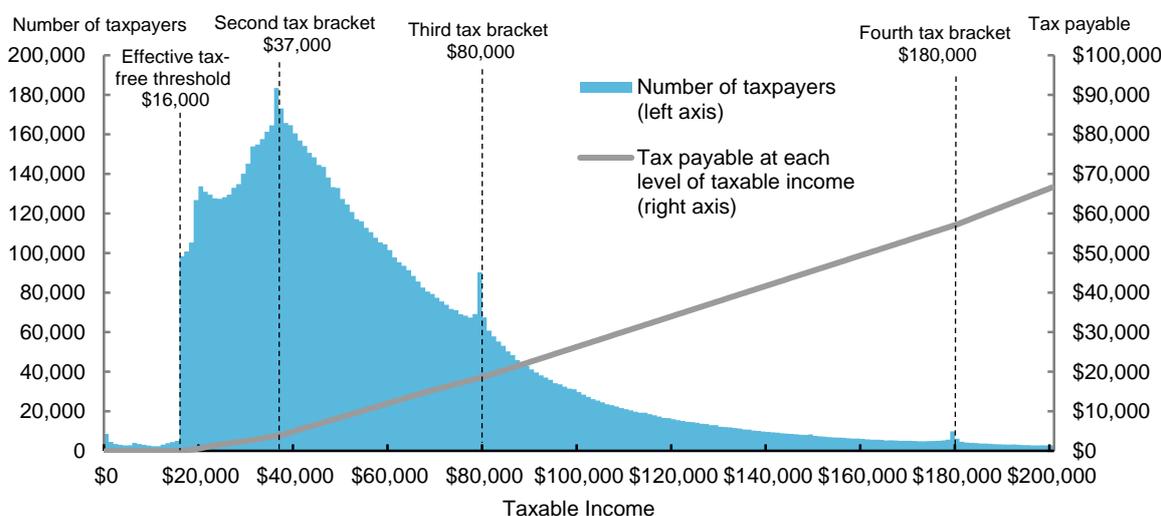
Box 3.1: Progressivity and the income of a household

Using an individual as the unit of assessment means that a couple with total taxable income of \$100,000 would have different tax outcomes depending on who earns how much of that total income.³² At one extreme, it may be a single-income couple with one person earning \$100,000 and paying tax of \$26,947 — an average tax rate of 26.9 per cent for the couple. At the other extreme, each member of the couple may earn \$50,000 and each pay tax of \$8,547 — an average tax rate of 17.1 per cent for the couple.

This tax outcome is sometimes criticised as ‘unfair’ as households with the same income pay different amounts of tax. However, taxing the individual improves the reward for effort for the secondary earner because they get a tax-free threshold, rather than facing the primary earner’s marginal rate on their first dollar of income.

The costs and benefits of using the household as the unit of assessment depend on how the tax thresholds are designed. If household tax thresholds were the same as individual tax thresholds, there would be no change for the single-income couple, while the double-income couple would pay more tax. If household tax thresholds were double individual tax thresholds, there would be no change for the double-income couple, while the single-income couple would pay less tax. If household tax thresholds were higher than, but less than double individual tax thresholds, the single-income would pay less tax, while the double-income couple would pay more tax.

Chart 3.2 Who paid individuals income tax, 2011-12



Note: The chart shows the number of tax filers who paid net income tax in thousand dollar taxable income brackets up to \$200,000. Tax payable is calculated by applying the individual income tax rate scale, LITO and the Medicare levy to taxable income.

Source: Treasury calculations using administrative data from 2011-12 tax returns for individuals.

Chart 3.2 shows the distribution of taxpayers across different taxable income levels. In 2011-12, most individual taxpayers had taxable income below the third threshold of \$80,000. However, the largest amounts of income tax are paid by individuals who have higher taxable

32 The example discussed in this box does not take account of the transfer system or any assistance the secondary earner may be entitled to if they have caring responsibilities.

income. Table 3.2 shows the number of individual tax filers with taxable income in each of the tax thresholds. In 2011-12, around 27 per cent of individuals had taxable income above the effective tax free threshold and below the \$37,000 threshold and paid around 4 per cent of the total share of individuals income tax. At the top end, around 2 per cent of individuals had taxable income above the \$180,000 threshold and collectively paid around 26 per cent of total individuals income tax.

As the tax thresholds are not indexed, bracket creep means that the proportion of individuals in the higher tax brackets will increase over time. For example, the percentage of taxpayers with income between \$80,000 and \$180,000 is expected to be around 23 per cent in 2014-15, and increase to 25 per cent by 2016-17.

Table 3.2 Individuals income tax by tax bracket, all individual tax filers, 2011–12

Taxable income band	Marginal income tax rate	Individuals — no.	Individuals — %	Net income tax — \$b	Net income tax — %
\$16,000 or less	0%	2,307,735	18.3	0.0	0.0
\$16,001 — \$37,000	15%	3,453,310	27.3	5.3	3.7
\$37,001 — \$80,000	30%	4,745,935	37.6	47.4	32.8
\$80,001 — \$180,000	37%	1,836,900	14.5	54.0	37.4
\$180,001 and over	45%	292,500	2.3	37.7	26.1
TOTAL	n.a.	12,636,380	100.0	144.4	100.0

Note: The effective tax free threshold in 2011-12 was \$16,000, after including the low-income tax offset. Totals are for those individuals lodging a tax return for that year.

Source: Treasury estimates using income tax returns for resident individuals for 2011-12.

What impact does individuals income tax have on economic growth and living standards?

As with all taxes, the imposition of tax on individuals income can adversely affect behaviour. This may be seen in people's decisions about how much, and where, they work and earn. Additionally, while there may be little impact on direct economic activity, it can also be seen in the way people choose to structure the way they save, invest or carry on a business (see Chapters 4 and 6). As shown in Chart 3.2, the distribution of taxpayers across the taxable income scale clusters around the tax thresholds, suggesting some people respond to increasing marginal tax rates. Compared to taxes with a relatively significant impact on economic growth and living standards (such as company tax), individuals income tax is usually considered to have a comparatively moderate impact on the behaviour of most people, and relatively minor adverse impacts on economic growth and living standards. However the impact on workforce participation (see section 3.3) should not be ignored, particularly in the context of an ageing population.

While individuals income tax raises significant revenue across taxpayers with middle incomes with relatively little impact on their behaviour, it can create greater distortions and lead to greater adverse effects for taxpayers at the lower and higher ends of the income scale. Generally this is due to the interactions that the individuals income tax system has with other parts of the tax and transfer system. Relatively low-income taxpayers, particularly the secondary (or lower) earner in a couple, may receive transfer payments that are withdrawn as their income increases and at the same time they begin to pay tax, reducing the immediate reward for work. At higher incomes taxpayers have greater capacity to legitimately structure their affairs to minimise the amount they pay and some may be more internationally mobile. These issues are discussed further in Section 3.3 of this chapter.

Discussion questions:

6. What should our individuals income tax system look like and why?

3.2: Overview of the fringe benefits tax system

What is fringe benefits tax?

FBT is payable on the ‘taxable value’ of fringe benefits provided to an employee by their employer in respect of their employment. The FBT rate is set at the top marginal tax rate plus the Medicare levy. It is currently 47 per cent, and will increase to 49 per cent from 1 April 2015 for a period of two years to reflect the imposition of the Temporary Budget Repair Levy.

A fringe benefit is anything (other than salary and wages) provided by an employer to an employee. This includes making a car available for an employee’s use or paying an employee’s home power bill. The breadth of the system means several exemptions are required to minimise the compliance costs of valuing very minor benefits. For example, allowing an employee to use office property on business premises — the office phone for a personal call or the office computer to send a private email — is an exempt benefit. Fringe benefits are not included in the employee’s assessable income for individual income tax purposes, but the value of benefits required to be reported is relevant to a number of income definitions used to means test transfer payments and tax concessions.

The taxable value of fringe benefits is determined by applying a range of different valuation methodologies, some of which provide concessional treatment (for example, on motor vehicle fringe benefits). Certain employers in the not-for-profit sector have scope to offer a greater range of concessional or exempt fringe benefits (also see Chapter 7).

How important is fringe benefits tax as a revenue source for government?

FBT was introduced as an integrity measure to ensure that all forms of remuneration paid to employees bear a fair measure of tax. While it only raised around \$4.3 billion in revenue in 2013-14 (or about 1.2 per cent of total Australian Government tax revenue),³³ it plays an important role in preserving the integrity of the individuals income tax system.

Who pays fringe benefits tax?

The legal incidence of FBT rests with the employer, but the economic incidence will vary depending on the extent to which the employer is able to effectively pass the tax through to the employee. Employees who receive fringe benefits through a salary sacrifice arrangement almost always bear the full economic incidence of FBT because they usually opt into these arrangements. In the long run, the economic incidence of FBT is generally expected to be on the employee.

Only Australia and New Zealand impose FBT on employers, with all other countries taxing fringe benefits in the hands of employees and using far fewer valuation rules, concessions and exemptions. The administration of the FBT system can be complex for employers. While FBT is paid by the employer, employers currently need to attribute certain fringe benefits to individual employees, and report the value of these fringe benefits on individual employee payment summaries. This is because some fringe benefits are included in income tests for transfer payments, taxes and tax concessions the employee may be eligible for.

Discussion questions:

7. What should our fringe benefits tax system look like and why?

3.3: Issues in the individuals income and fringe benefits tax systems

Over recent decades there have been significant reforms to Australia's individuals income tax system. They have included the introduction of capital gains tax and FBT in the mid-1980s; integrity measures like the introduction of non-commercial loss rules and expanded definitions of income to better target concessions in the 2000s; and the recent abolition of poorly targeted concessional tax offsets.

Nevertheless, there may still be scope for further reforms of our individuals income tax system given the impact that the individuals income tax system can have on economic

³³ Australian Government 2014, *2013-14 Final Budget Outcome*, Australian Government, Canberra.

growth and living standards. This section discusses some of the issues that may warrant further consideration. Some of them arise from competing objectives and interactions with the transfer system. Others come from features of the tax system that may no longer be appropriate to a modern economy and societal expectations.

Bracket creep

As discussed in Chapter 2, bracket creep erodes the real rewards for effort over time, and exacerbates existing disincentives to participate in the workforce and the incentives for tax planning and structuring. While it is important for governments to address the impact that unchecked bracket creep can have, it is also important to consider the features inherent in the current design of the individuals tax system that reinforce the need to hand back bracket creep in the form of tax cuts.

Governments have responded to these issues by adjusting the thresholds periodically and providing tax cuts. As discussed below, it is important that barriers to workforce participation are limited in order to protect Australia's living standards as our population ages. While other factors in the tax and social security systems may also contribute to potential work disincentives, bracket creep is an important consideration in maintaining reward for effort and the integrity of our tax system.

Discussion questions:

8. At what levels of income is it most important to deliver tax cuts and why?

Implications for labour supply

Potential workforce participation disincentives

Australia's workforce participation rates,³⁴ particularly female participation rates, are lower than most comparable Organisation for Economic Co-operation and Development (OECD) countries. For example, while the participation rate of women between the ages of 15 and 64 in Australia has increased from 65.3 per cent in 2000 to 70.5 per cent in 2013, Australia is ranked 13th of the 34 OECD countries for female participation.³⁵ With an ageing population leading to a higher proportion of the population in retirement it will be important to ensure that barriers to participation are minimised.

An unavoidable feature of the progressivity in the individuals income tax system, combined with targeted assistance in the transfer system, is the creation of high effective tax rates that reduce the immediate rewards for work. A person choosing to pick up an additional shift may pay more tax on that income or receive a smaller amount of any means-tested transfer

34 To be counted as participating in the workforce, a person must either be working or actively be looking for work.

35 OECD 2014, *Labour Force Statistics*, OECD, Paris, viewed 11 November 2014: http://stats.oecd.org/Index.aspx?DataSetCode=LFS_SEXAGE_I_R.

payment they are eligible to receive. Effective tax rates are the proportion of any increase in income that is lost to tax or the withdrawal of transfer payments and may reduce incentives to work.

Reducing effective tax rates is not straightforward because reducing the rate at which payments are withdrawn, or removing targeting altogether, would extend assistance to higher income levels. Alternatively, removing taper rates while still preserving targeting would mean that people would face abrupt losses of entire payments. Further, effective tax rates capture the withdrawal of the transfer payment itself, but do not reflect the abrupt loss of any associated benefits which only happens when a person loses their very last dollar of payment.

Given the complexity of the interactions between various components of the tax and transfer systems it is possible that some people do not have a good understanding of how their participation decisions affect their disposable incomes. The two systems have different units of assessment, different periods of assessment and reconciliation, and differences in the timeliness of assistance. It is therefore difficult to say how important effective tax rates actually are in driving participation decisions at the margin, although it is likely that most people are broadly aware of the impact of substantial changes to the numbers of hours they work.

The extent to which someone's workforce participation is influenced by effective tax rates also depends on the particular circumstances of the individual and their household. The groups most likely to respond to high effective tax rates include the unemployed and lower-income earners (who often work part-time).^{36,37} Primary care givers, such as parents with young children, are also relatively responsive to effective tax rates but they also respond to other costs associated with working, such as child care — particularly if they are single parents or the secondary earner in a couple.³⁸ Another consideration is access to public housing.

Decisions about whether or how much to work can also be driven by non-financial considerations, such as the intrinsic value people place on either their work or on their roles outside work. People may also value the potential longer-term benefits of attachment to the workforce (such as implications for future promotions or pay increases) and weigh these against the function they wish to perform outside work, such as caring. These issues are being considered as part of the Government's families package.

In the absence of any changes to payments or assistance, and all else being equal, targeting tax cuts at the lower end of the income spectrum should generate a higher participation response than if the same value of tax cuts were delivered at higher incomes. This is because relatively low-income individuals are more likely to be working part-time or on a casual basis (as shown in Chart 3.3), and be more responsive to changes in disposable

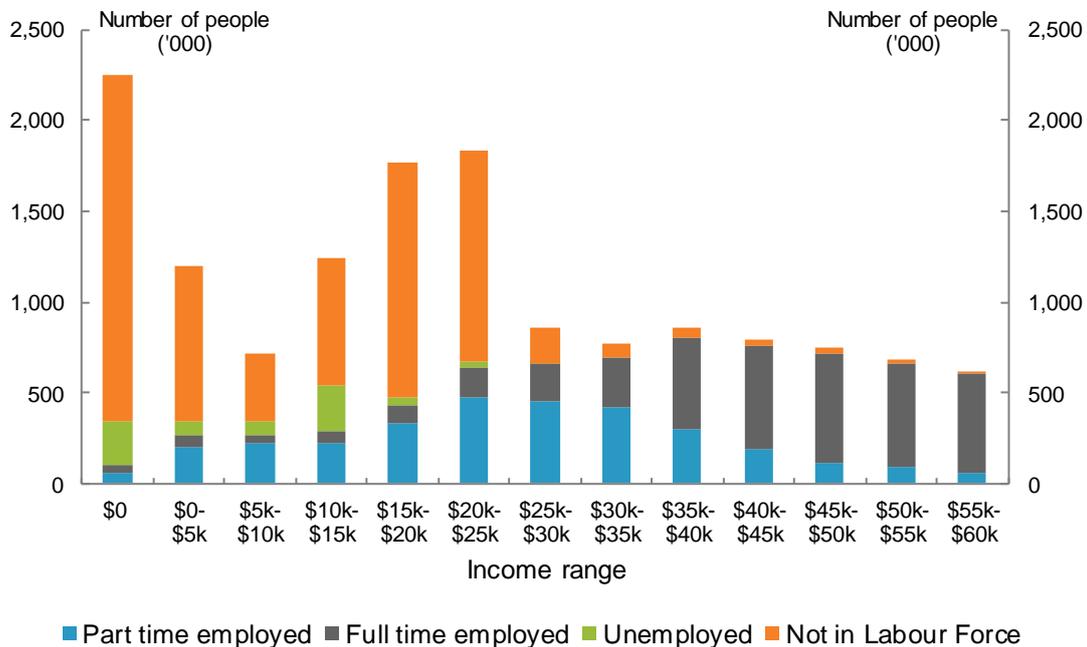
36 Dockery, M., Ong, R. and Wood, G. 2007, 'Welfare traps in Australia: Do they bite?' Paper presented to the HILDA Survey Research Conference, 19-20 July Melbourne.

37 OECD 2011, *Taxation and Employment*, tax policy studies no. 21, OECD Paris, pages 34-35.

38 Blundell, R., Dunanc, A. and Meghir, C. 1998. 'Estimating labor supply responses using tax reforms', *Econometrica*, 66:4:827-861; Dandie, S. and Mercante, J. 2007, *Australian labour supply elasticities: Comparison and critical review*, working paper no. 2007-04, Australian Treasury, Canberra.

income. In addition, the same dollar value increase or decrease (which would be a bigger proportion of earnings at relatively low levels than at the higher end) will potentially provide a bigger incentive for increased workforce participation.

Chart 3.3 Employment status by taxable income, 2014-15



Source: Treasury estimates using Treasury’s version of STINMOD

Discussion questions:

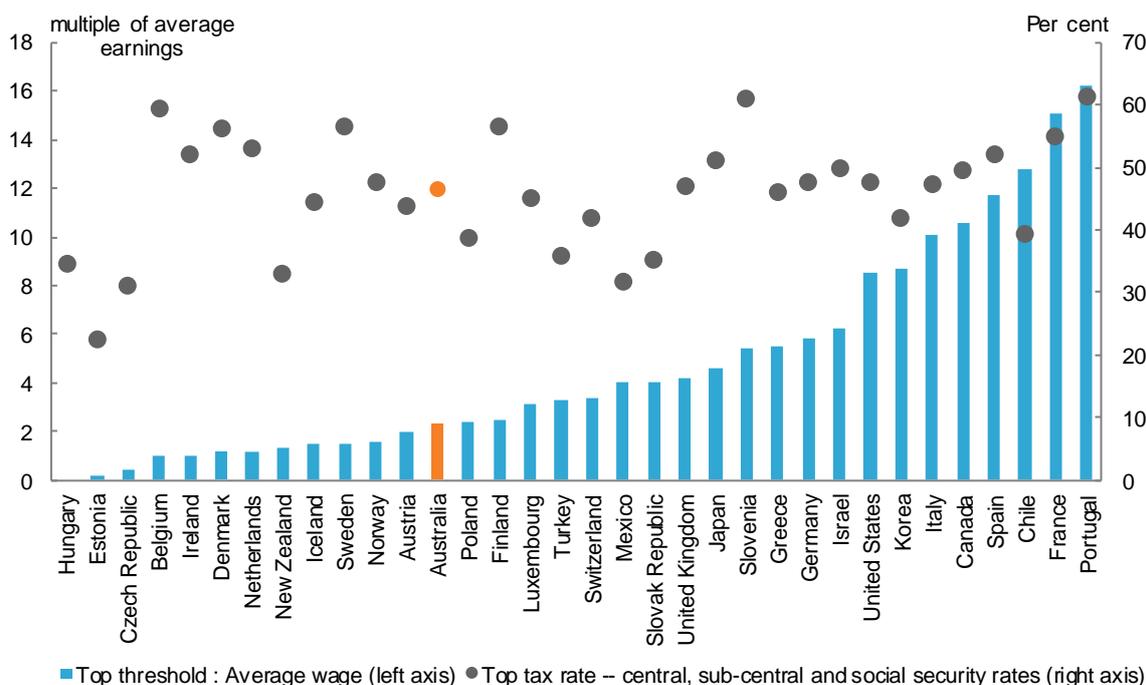
- 9. To what extent does taxation affect people’s workforce participation decisions?
- 10. To what extent are the interactions between the tax and transfer system straightforward for the people who deal with both systems?

International labour mobility

Labour is typically less mobile than capital, but it is not perfectly immobile. Australia has a higher top marginal tax rate than several key countries in our region. The rate itself is relatively similar to other OECD countries once any state or provincial income tax rates that apply in other countries are included in the comparison. That said, Australia’s top marginal tax rate takes effect from a threshold of around 2.3 times the average wage — a relatively low income threshold compared to other OECD countries, such as the UK at 4.2 times the average wage, the US at 8.5 or Canada at 10.6 (Chart 3.4). However, tax is only one factor affecting the decisions of workers who are mobile. Other reasons include salary potential; quality of life; language and culture; family and social connections; and immigration restrictions.

Empirical evidence on the extent to which income tax rate differentials drive migration is limited. What is available for other countries suggests that tax rate differentials have only a small impact on migration, but that where there is an impact, it is generally larger for highly skilled, or for younger, highly educated workers.³⁹ In Australia, younger workers may be making income contingent repayments on higher education contribution scheme (HECS) or higher education loans programme (HELP) debts which can add up to eight percentage points to amounts withheld from their salary during the year.

Chart 3.4 Top marginal tax rates comparison, OECD countries, 2013



Note: Numbers for Australia are for 2013-14. Australia's top marginal tax rate for 2014-15 has increased to 49 per cent (45 per cent top statutory personal income tax rate plus 2 per cent Medicare levy plus 2 per cent Temporary Budget Repair Levy).

Source: OECD 2014, *Tax Database — Personal Income Tax Rates*, OECD, Paris, viewed 24 November 2014: www.oecd.org/ctp/tax-policy/tax-database.htm#pird.

As at 2010, 16 OECD countries offered concessions on individual income tax and/or social security contributions to attract 'knowledge workers', researchers, managers or specialists — including incentives targeted at encouraging residents who currently live in other countries to return home.⁴⁰ Some countries also provide concessions on employee remuneration in the form of shares or options to assist start-ups to attract employees.⁴¹

People at the higher end of the income scale face higher tax rates and have greater capacity to meet the costs of relocating. The emigration of skilled workers, who generally have high earning potential is sometimes viewed as a cost to the economy, characterised as 'brain

39 OECD 2011, *Taxation and Employment*, tax policy studies no. 21, OECD, Paris, pages 128-129.

40 OECD 2011, *Taxation and Employment*, tax policy studies no. 21, OECD Paris, page 137.

41 In Australia last year, the Government announced it will reform the tax treatment of employee share schemes in part to improve the competitiveness of innovative firms in Australia looking to attract and retain high-quality employees in the international labour market (discussed further in Chapter 5).

drain' associated with the loss of returns on investment in human capital. However, workers who temporarily leave Australia and then subsequently return can bring back new skills, knowledge and networks, with positive flow-on benefits for innovation and growth.

Discussion questions:

11. How important is tax as a factor influencing people's decisions to work in other countries?

Balancing competing objectives

One of the pressures on the individuals income tax system is that it is expected to raise revenue as simply as possible, while also being economically efficient and delivering fairness with a progressive schedule of rates and thresholds. There can be a trade-off between simplicity and fairness in particular, and a balance between these objectives must therefore be managed. For a given amount of revenue the broader the base, the lower the rates required — this combination could potentially satisfy all three objectives.

Tax planning and progressivity

Progressivity in the individuals income tax system is delivered through the schedule of marginal rates and thresholds, which apply to a person's taxable income. These headline rates and thresholds create an expectation that people on high incomes pay a higher average tax rate than people on low incomes. At the same time there are features of the tax system that can produce outcomes that diverge from the headline rates (for example, Chart 4.1, which shows the tax outcomes associated with different forms of saving). These features may exist to encourage particular behaviours (for example, high effective tax-free thresholds can improve the immediate rewards for work, and concessional tax superannuation can improve retirement income adequacy), or to reduce complexity or compliance burden (for example, allowing a 50 per cent capital gains tax discount instead of indexation and averaging arrangements).

Some people may not give any thought to these features of the tax system when they conduct their affairs. Others may legitimately plan their affairs to take maximum advantage of these features, so that the amount of tax they pay is less than the amount that would otherwise be determined by the headline rates and thresholds. This can affect perceptions of fairness of the individuals income tax system, particularly since the parts of the tax system that create the incentives for tax planning are not as well understood as the headline rates and thresholds.

'Tax planning' refers to the use of legitimate, legal strategies to reduce the amount of tax paid⁴² and can allow some people to reduce the amount of tax they pay without reducing their actual income. Tax planning in the individuals income tax system can come from reducing assessable income or claiming deductions. It can also involve income splitting,

42 This is distinct from 'tax evasion', which is non-compliant behaviour (such as not declaring income).

where income is attributed to more than one individual, or is distributed across more than one income year, in order to take advantage of more than one tax-free threshold. The benefits of common, legitimate tax planning strategies arise from a number of features of the tax system, including high effective tax-free thresholds; the difference between marginal tax rates and the company tax rate; the capital gains tax discount; the tax treatment of superannuation; and concessions or exemptions in the fringe benefits tax system.

Box 3.2: Income definitions

A number of the concessions and offsets administered through the tax system are targeted using means tests that use an expanded definition of income. There are several different definitions of income used for this purpose in the individuals income tax system.

Each definition seeks to better reflect a person's means by taking account, in some way, of some or all of: voluntary superannuation contributions; fringe benefits; net investment losses (rental and financial); foreign income; and government payments that are exempt from tax.

Currently, none of the income definitions used in the individuals income tax system include the capital gains tax discount, the value of exempt fringe benefits, or tax-free superannuation. As information about these is not collected for tax purposes, it is difficult to determine the extent to which they are used by people at different income levels.

The number of income definitions, and the extent to which they vary, adds significant complexity to the tax system — particularly for people trying to work out their eligibility for multiple concessions or offsets.

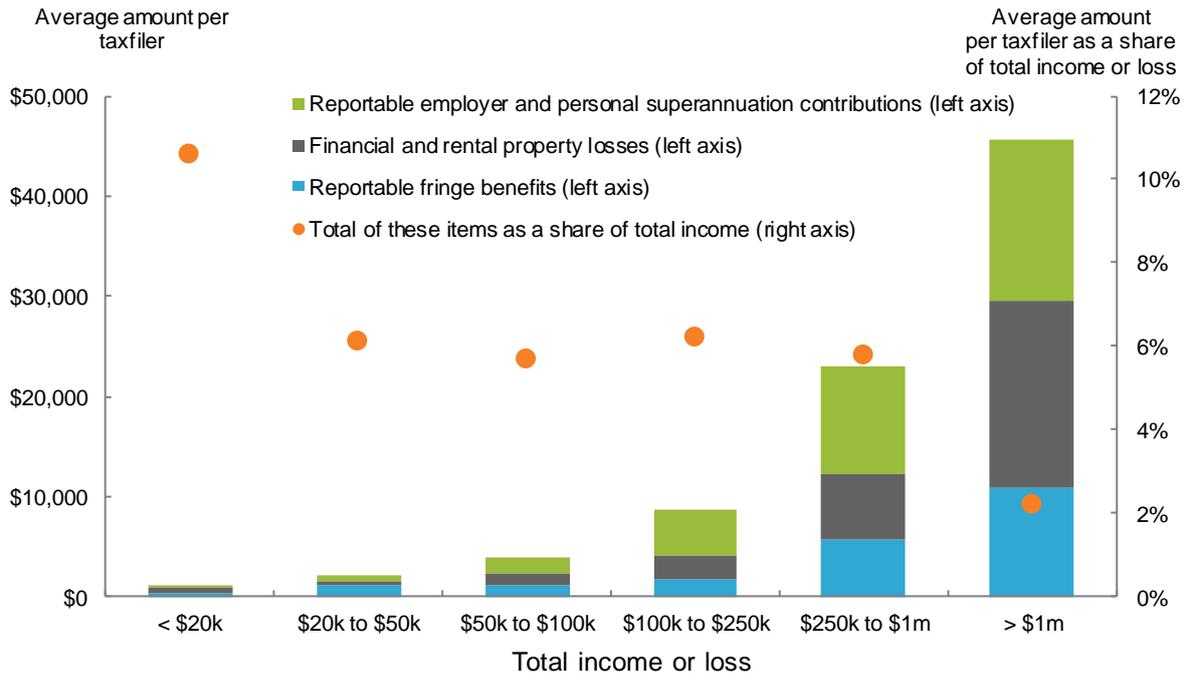
A further source of compliance burden arises when income tests are applied based on the income of a couple, which must be administered through the individuals income tax system that is designed using the individual as a unit of taxation.

While taxable income by definition determines the amount on which tax is paid, some of the concessions in the tax system are means tested using expanded definitions of income, which are designed to reduce the benefits from tax planning. Over time, these income definitions have evolved to better reflect an individual's means (Box 3.2). Requiring taxpayers to report additional items adds to compliance burden. However, these income definitions better target assistance and collect data that can give an indication of the use, by income level, of certain concessions that would otherwise not be required to be reported by an individual.

Reducing assessable income and maximising deductions

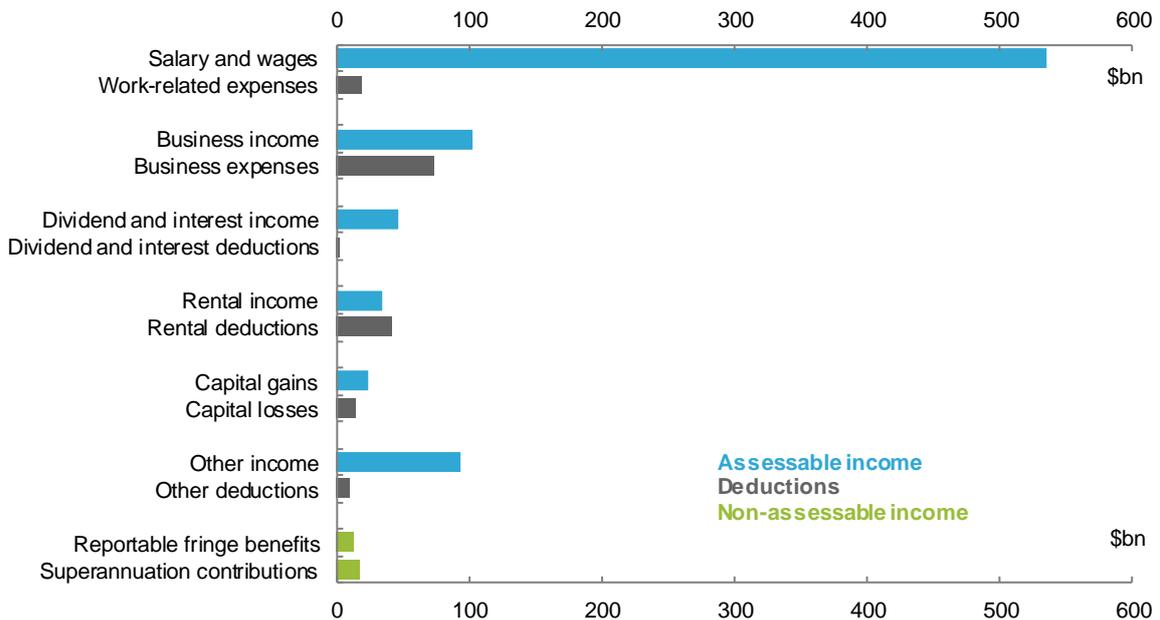
One way employees can reduce their tax liabilities is by reweighting their remuneration away from wages towards concessionally taxed superannuation contributions (up to a prescribed cap), or to fringe benefits that are concessionally taxed or exempt from tax. Another way is to apply losses from other activities to reduce the amount of tax payable on wage or salary income. Unsurprisingly, the use of these approaches is higher among people on higher assessable incomes, but not disproportionately so (see Chart 3.5). It is difficult to draw any conclusions on the implications this may have for the progressivity of the individuals income tax system, as greater use of fringe benefits or superannuation would reduce assessable and taxable income. Further, the data is sourced from the individual income tax return, and therefore does not reflect the use of unreported or exempt fringe benefits.

Chart 3.5 Use of concessions and losses, by total income, 2011-12



Source: Treasury estimates based on ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

Chart 3.6 Major sources of income and deductions, 2011-12



Notes: 'Business income' and 'business deductions' are income earned and deductions incurred by individuals carrying on a business (for example, as a sole trader). 'Other income' includes distributions from partnerships and trusts; taxable Australian Government transfer payments; and allowances, benefits, earnings and tips. 'Other deductions' includes charitable donations and the cost of managing tax affairs. 'Superannuation contributions' includes reportable employer superannuation contributions and personal superannuation contributions, but not superannuation guarantee contributions. 'Reportable fringe benefits' does not fully reflect remuneration in the form of fringe benefits as, among other things, it does not include fringe benefits below the \$2,000 threshold (that are not required to be reported) or fringe benefits that are exempt from tax.

Source: ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

People can also reduce their taxable income by claiming deductions, although there is generally only a tax planning benefit from claiming deductions that provide a private benefit. In the case of work-related expense deductions the tax planning benefit is limited by the requirement that these expenses should generally be apportioned based on how much is for private use. There is generally greater scope to claim legitimate deductions related to income from savings or from carrying on a business. Business or investment deductions usually make up a greater share of the income they are linked to, compared to work-related expense deductions and wage and salary income (Chart 3.6).

Income splitting

Outside of the individuals income tax system, people may be able to use entities such as trusts or private companies to 'income split'. The potential benefits from income splitting arise from the progressivity and effective tax-free thresholds in the individuals income tax system (Box 3.3). Legitimate income splitting is not straightforward to do. This is because the general anti-avoidance rule and other integrity rules in the tax law are intended to counter schemes that have a 'dominant purpose' of avoiding tax, even though they comply with the technical requirements of the tax law. For example 'personal services income' is the reward for someone's personal efforts or skills and should be taxed according to that person's marginal rates. A special tax regime for personal services income exists to prevent people from reducing their tax by shifting this income to another person or entity (such as a company).

A further incentive for tax planning is the difference between the marginal rates in the individuals income tax system and the company tax rate, which can allow incomes to be split between individuals to take advantage of different personal marginal rates of tax, and further, allow tax to be deferred by retaining profits in a company structure. This can increase the incentives to carry on a business through, or hold wealth in, private companies. However, there are integrity provisions aimed at preventing private companies from making distributions of profits to shareholders without paying additional tax through the personal income tax system. Income splitting is discussed further in Chapter 6.

Box 3.3: Income splitting

Going back to the single-income couple in Box 3.1: if the \$100,000 is their only income and they are able to legitimately income split, they could distribute the \$100,000 equally between them, so that their average tax rate is 17.1 per cent as a couple, compared to 26.9 per cent above.

If the couple has children or other family members, they could benefit further by distributing the income to them as well. For example, if they have two children over the age of 18, they can distribute \$25,000 to each member of the family, and each pay tax of \$1,293, or an average tax rate of 5.2 per cent.

If the children are under 18, then there is little benefit in distributing more than \$416 to each child as the rate of tax on a minor's 'unearned' income (that is, other than income from working) is deliberately high in order to discourage income-splitting to, or holding assets in the name of, minors.

Discussion questions:

12. To what extent is tax planning a problem in the individuals income tax system? Are existing integrity measures appropriate?
13. What creates incentives for tax planning in the individuals income tax system? What could be done about these things?

Targeting assistance in the tax system

Direct assistance, like income support payments or family assistance, is delivered through the transfer system. The tax system generally cannot deliver tax assistance to people with the lowest taxable incomes because they do not pay any tax.⁴³ Tax offsets are the main delivery mechanism for assistance but, as the tax and transfer systems have evolved over time the extent to which some of the remaining offsets are appropriate is questionable.

Structural offsets

Some transfer payments are taxed, others are not. Recipients of Australian Government transfer payments that are taxed are eligible for either the SAPTO or the BENTO (on top of the LITO). This is so that maximum rate payment recipients effectively do not pay tax on their payment income, but delivering this outcome through offsets is a confusing arrangement and is not transparent about their actual tax outcome. As a result, some payment recipients may believe they are being unfairly taxed on their Australian Government payments when in fact they are not. Further, the current effective tax-free threshold of \$20,542 is higher than or only slightly below the maximum rate of many benefits and pensions. Maximum rate payment recipients, for whom these offsets were created, therefore receive little or no benefit from structural tax offsets.

The SAPTO and BENTO now provide the greatest benefit to people who have some private income as well as some payment income. This can smooth the transition for a person who is moving from income support to working. However, it means that people who have some transfer payment income pay less tax than someone who only has income from working (Box 3.4). Addressing this issue is not straight forward. Exempting transfer payments from tax altogether entails greater transparency for maximum rate payment recipients, and may mean that some of them no longer need to deal with the tax system. However, doing so would come at a cost, and would worsen the outcome that structural offsets can create.

43 The tax system can be used to administer assistance related to other programmes, such as the private health insurance rebate.

Box 3.4: Tax outcomes — with and without structural offsets

In 2014-15, a student receiving the full rate of Youth Allowance receives \$10,936.⁴⁴ If they also work part-time to earn the maximum allowable private income (for a Youth Allowance recipient) of \$10,946 per year, then their total taxable income is \$21,882. Because their tax liability before offsets and Medicare levy is \$700 and they are entitled to \$445 of LITO and \$740 of BENTO, they pay no tax.

Someone who earns \$21,882 without any government payments would also have a tax liability of \$700 before offsets and the Medicare levy. However, since they do not receive any direct government assistance, they are only eligible for \$445 of LITO, which leaves them with a remaining tax liability of \$255.

Concessional offsets

Concessional offsets provide assistance to certain groups of taxpayers, but their delivery may be less effective than the assistance provided by the transfer system. People generally need a tax liability to benefit from offsets, and assistance is generally payable after assessment of tax returns rather than during the year. Some people may not know that they benefit from offsets, as offsets may be claimed on their behalf by a tax agent or calculated by the Australian Taxation Office. Further, the amount of assistance available through concessional offsets is often not adequate to fully assist people in genuine need throughout the year. For these reasons many concessional offsets have been abolished in recent years.

The remainder of the concessional offsets to which more of these issues apply are the dependent (invalid and carer) tax offset, zone tax offset, net medical expenses tax offset, and employment termination payment tax offset. The dependent (invalid and carer) tax offset is available to taxpayers who contribute to the maintenance of a dependant who is unable to work due to a carer obligation or a disability. The maximum value of assistance provided by the dependent (invalid and carer) tax offset (around \$2,500) is significantly less than the direct assistance provided through the transfer system to carers or people with disabilities. The maximum value of net medical expenses tax offset a person can receive is 20 per cent of the amount by which their eligible expenses exceed \$2,162, which means a person must first incur the expenses during an income year, and then determine whether they can receive any assistance upon assessment of their tax return.

The employment termination payment tax offset was originally intended to concessional tax lump sum payments made on termination of employment, as a form of tax smoothing and retirement income support. Over time its purpose has become less certain. The introduction of the superannuation system has superseded the offset's retirement income objective, and the introduction of a maximum cap on the amount of offset a person can receive limits the extent to which it can actually smooth the effects of lumpy income.

44 This rate is for a single student under the age of 18 with no children, who is required to live away from their parental home to study, undertake training, or look for work. The amount is the annual average for 2014-15.

In the case of the zone tax offset, submissions to recent inquiries suggest that it may no longer meet its original policy intent. As the zone tax offset is administered based on geographic boundaries that were last updated in 1981, some people question whether the areas within the zone are truly those with the highest living costs or remoteness. Further, in a recent report tabled by the House Standing Committee on Regional Australia in February 2013,⁴⁵ some of the submissions raised the concern that ‘fly-in, fly-out’ workers should not receive the zone tax offset. This was on the grounds that fly-in, fly-out workers tend to spend and invest their money where their families reside, and do not necessarily incur the higher costs of living in the zone.

Discussion questions:

14. Under what circumstances is it appropriate for assistance to be delivered through tax offsets?

Compliance burden

Work-related expense deductions

Compared to some other countries, Australia’s tax system is relatively generous in respect of work-related expense (WRE) claims, which are widely utilised. In 2011-12, around 8.5 million people claimed WREs totalling nearly \$19.4 billion,⁴⁶ although around 38 per cent of tax filers had claims of less than \$500. Under Australia’s approach individuals are able to claim a broad range of WREs against their assessable income as long as they are used for work. To reduce compliance burden and allow greater use of pre-filled income tax returns, Australia has in the past considered, but not proceeded with, a ‘standard deduction’ on WREs (Box 3.5).

The approaches of some other countries are more prescriptive or limited. For example, the United Kingdom specifies a tighter nexus on WREs and limits deductions to those that are incurred wholly, exclusively and necessarily in the performance of an employee’s duties, although the compliance burden associated with substantiating deductions remains. New Zealand ‘cashed out’ WRE deductions in the late 1980s by providing income tax cuts in exchange for disallowing WRE deductions. This has been a major driver of compliance savings by reducing the number of people needing to file a tax return — in the 2012 tax year around 1.25 million individual tax returns were filed in New Zealand⁴⁷ out of an estimated 3.3 million individual tax payers.⁴⁸

45 House of Representatives 2013, *Inquiry into the use of ‘fly-in, fly-out’ (FIFO) workforce practices in regional Australia*, Standing Committee on Regional Australia, Canberra.

46 ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

47 Inland Revenue Department of New Zealand 2014, *Returns Filed 2004 to 2013*, Inland Revenue, viewed 1 December 2014, www.ird.govt.nz/aboutir/external-stats/tax-returns/returns-filed/.

48 The Treasury (New Zealand) 2012, *2012 Budget Key Facts for Taxpayers: Who pays income tax ... and how much?*, New Zealand Government, viewed 1 December 2014: www.treasury.govt.nz/budget/2012/taxpayers/02.htm.

Despite the compliance burden associated with WRE deductions in Australia they are valued by those who claim them. Tightening the arrangements for WRE deductions in Australia would require careful consideration of how to manage legitimate expenses incurred by employees. In some cases, the expense could be met by an employer providing the necessary item (for example, uniforms or protective equipment), and then having the item returned if the employee leaves. In other cases, this is less straightforward, such as with self-education expenses where the benefit is embodied in the employee's human capital. These arrangements would also need to be coordinated with the FBT regime so that employers could provide employees with things that may no longer be 'otherwise deductible' without attracting FBT on those things.

It is also possible that the existing arrangements for self-education expense deductions are somewhat restrictive, particularly when structural change in the economy makes re-training more important to meet ever-changing labour demand needs. This is because self-education expenses may only legitimately be claimed if they maintain or improve the specific skills or knowledge required in someone's *current* employment. Someone working in one occupation, who is seeking to retrain or reskill so that they can transition to another occupation, generally cannot deduct that expenditure. However, any loosening of this eligibility could lead to problems with compliance.

Box 3.5: A standard deduction for WREs

Given the high proportion of taxpayers who incur a relatively low total value of legitimate WREs, a 'standard deduction' could provide significant compliance savings. Rather than substantiating WRE expense claims with receipts, these taxpayers could instead choose to 'tick a box' to claim a standard deduction at a set amount (for example, \$500).

While it could deliver a simplicity benefit, a standard deduction would come at significant cost — people who do not currently have any WRE deductions could reduce their taxable income by the value of the standard deduction.

Discussion questions:

15. To what extent do our arrangements for work-related expense deductions strike the right balance between simplicity and fairness? What could be done to improve this?

Fringe benefits tax

Australia's FBT system was designed to fill a perceived gap in the income tax base. However, the imposition of highly prescriptive rules to cover every possible fringe benefit provided by an employer to an employee means that it is highly complex. Further, much of the complexity in FBT arises when working out who is not liable and which fringe benefits are exempt or excluded from FBT reporting requirements.

As with the offsets in the individuals income tax system, some of the concessions and exemptions in the FBT system may not be well targeted. For example, the use of child care services provided for the benefit of employees on an employer's business premises is exempt from FBT. This can create inequities in the provision of child care services as not all employers are likely to be able to provide such services. Further, the largest benefits go to individuals on the top marginal tax rate. Another area of concern is the FBT concessions for remote area housing and exemptions for transporting fly-in, fly-out employees. Some longer-term residents of rural and remote areas claim that this encourages fly-in, fly-out arrangements, which can contribute to higher rents.

The complexity of Australia's FBT system may be exacerbated by the fact that the legal incidence rests with employers. Three taxing systems apply to each fringe benefit (FBT, income tax and GST), and several methodologies are available to employers in calculating the FBT liability in relation to certain fringe benefits. This adds unnecessary compliance costs for employers, with FBT forms taking 12 hours on average to complete, compared to two hours on average for a business activity statement or six hours on average for a superannuation return.⁴⁹

Discussion questions:

16. To what extent does our fringe benefits tax system strike the right balance between simplicity and fairness? What could be done to improve this?
17. To what extent are the concessions and exemptions in the fringe benefits tax system appropriate?

49 ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra.