

## 7. Income Tax

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### Contents

Summary	151
Income tax and workforce participation	151
Effective Marginal Tax Rate	152
Complexity of the tax transfer system	153
Exemptions	153
Tax offsets	154

### Summary

7.1 Personal income tax laws may affect workforce participation, including for mature age cohorts. Addressing this issue requires consideration of systemic reforms to the tax system—a task beyond the scope of this Inquiry. The 2009 Australia’s Future Tax System Review (the Tax Review) has recommended cohesive tax reform with a view to incentives for workforce participation. This chapter discusses several aspects of the income tax system that may be pertinent to mature age workforce participation and notes relevant Tax Review recommendations.

### Income tax and workforce participation

7.2 Personal income tax has been linked to workforce participation. The imposition of income tax, together with reductions in income support payments (‘transfers’) as people earn more income, reduces the financial rewards from work, which may make work less attractive.<sup>1</sup> Higher tax rates can reduce incentives to work since people have a smaller marginal gain from employment and they may consequently choose not to undertake paid work. Conversely, others may work more to achieve a certain target level of income that they consider adequate for their needs. In economic terminology, these contrary effects are described as the ‘income effect’ and the ‘substitution effect’.<sup>2</sup>

7.3 The Issues Paper discussed several aspects of the income tax system in relation to mature age workforce participation, including:

- Effective Marginal Tax Rates (EMTRs);
- the complexity of the tax transfer system;

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1 See: The Treasury, *Australia’s Future Tax System: Architecture of Australia’s Tax and Transfer System* (2008), 239.

2 FaHCSIA, *Pension Review Report* (2009), 18. Higher tax rates and smaller marginal gains from employment may mean that some people will choose leisure time over work.

- tax exemptions for social security payments; and
- tax offsets.

7.4 Responses from key stakeholders largely focused on systemic reforms to the tax system. For example, the Australian Council of Trade Unions (ACTU) stated that, having regard to the Inquiry’s framing principles of system coherence and stability, it would not support ‘significant structural change to one payment ... in the absence of change to other forms of income support payments’.<sup>3</sup>

7.5 Systemic tax reform is beyond the scope of this Inquiry. Further, such a project was completed in 2009, when the Tax Review examined, and recommended cohesive reforms to, the tax transfer system with a particular focus on ensuring appropriate incentives for workforce participation.<sup>4</sup>

7.6 Consequently, this section does not propose reforms to income tax laws. It summarises the income tax issues raised in the Issues Paper and the responses from key stakeholders, and points to relevant Tax Review recommendations.

### **Effective Marginal Tax Rate**

7.7 EMTR is the percentage of additional income lost due to the withdrawal of means-tested benefits (such as social security payments) and additional income tax payable as a result of working. A higher EMTR may discourage workforce participation, including among mature age cohorts. As found in the Tax Review, ‘effective tax rates can be high for some people, including for those likely to reduce their level of work as a result’.<sup>5</sup>

7.8 The ACTU suggested that people are more likely to work ‘if they keep a larger proportion of an extra dollar they earn, in particular, low-income earners who are more responsive to changes in their net incomes’. However, it stated that tax reforms should be targeted at low and middle income earners, ‘where they get the biggest “bang for the buck”’—therefore arguing against tax cuts for higher-income earners aged over 45 years.<sup>6</sup>

7.9 COTA Australia (COTA) was also concerned with reducing the EMTR, stating that:

The interaction of the now increased income tax free threshold, income free threshold, taper rates and marginal tax rates need to be examined to see if there are ways to reduce the effective marginal tax rates that people face when they move between the transfer and tax systems.<sup>7</sup>

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3 ACTU, *Submission 38*. See also: COTA, *Submission 51*; Olderworkers, *Submission 22*.

4 The Treasury, *Australia’s Future Tax System: Final Report* (2010), pt 1, vii, Terms of Reference.

5 Ibid, pt 2, vol 1, 21.

6 ACTU, *Submission 38*.

7 COTA, *Submission 51*. As discussed below, from 1 July 2012, the Australian Government has increased the tax-free threshold: Australian Government, *Budget 2012–13: Budget Overview (2012)* (2012) <[www.budget.gov.au](http://www.budget.gov.au)> at 3 September 2012, ‘Tax Reform—Road Map’.

7.10 The Tax Review addressed this issue in a ‘key point’ underpinning recommended reforms to this area. It stated that the income tax system should ‘support workforce participation by limiting high effective tax rates, especially for those people who are likely to be most responsive to financial incentives to work’.<sup>8</sup>

### Complexity of the tax transfer system

7.11 There may be circumstances where a person decides not to work as it is simply too complex to determine whether it would be more financially advantageous to work or not.<sup>9</sup> Olderworkers noted that in a survey of jobseekers aged over 45 years, a large percentage considered the tax transfer system ‘extremely complex’. It stated that to encourage mature age workforce participation, the Australian Government should ‘develop a much less complex tax-transfer system’.<sup>10</sup>

7.12 Reducing tax system complexity requires systemic and comprehensive reforms, and was a specific focus of the Tax Review.<sup>11</sup> The Tax Review recommended 16 specific reforms to the personal income tax system.<sup>12</sup>

7.13 Another way to address complexity in the tax system is through providing information to mature age persons. COTA stressed the value of ‘easy to understand, clear and concise information’, suggesting a free service to provide accurate information based on individual circumstances.<sup>13</sup> Similarly, the Australian Chamber of Commerce and Industry (ACCI) suggested more ‘promotion of seminars and programs to mature aged [so they can] understand the range of tax benefits available’.<sup>14</sup> Information about income tax—including income tax calculators—is contained on the Australian Securities and Investments Commission’s ‘Moneysmart’ website and the Australian Taxation Office website.<sup>15</sup>

### Exemptions

7.14 Another issue raised in the Issues Paper was tax exemptions for social security payments.<sup>16</sup> By way of background, tax is levied on the *taxable income* of a taxpayer derived during the income year. Taxable income is calculated by deducting all

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8 The Treasury, *Australia’s Future Tax System: Final Report* (2010), pt 2, vol 1, 11.

9 In the Issues Paper, the ALRC asked whether the complexity of the tax-transfer system could be minimised to remove barriers to mature age workforce participation: Question 6. See discussion of system coherence in Ch 1.

10 Olderworkers, *Submission 22*.

11 The Treasury, *Australia’s Future Tax System: Final Report* (2010), pt 1, vii, Terms of Reference.

12 *Ibid*, Recs 2–17.

13 COTA, *Submission 51*.

14 Australian Chamber of Commerce and Industry, *Submission 44*.

15 ASIC, *Moneysmart website* <[www.moneysmart.gov.au](http://www.moneysmart.gov.au)> at 30 August 2012; ATO website <[www.ato.gov.au](http://www.ato.gov.au)> at 11 April 2012.

16 The ALRC asked whether these exemptions affect mature age workforce participation: Question 7.

allowable deductions from the taxpayer's *assessable income*.<sup>17</sup> An amount of income will not form part of a person's assessable income if exempt.<sup>18</sup>

7.15 Most social security payments are assessable, with a portion of the payment exempt.<sup>19</sup> A tax exemption applies to Disability Support Pension (if the recipient is under Age Pension age), Wife Pension (if both spouses are under Age Pension age), and Carer Payment (if the carer and care receiver are under Age Pension age).<sup>20</sup> Only supplementary amounts of these payments, such as rent assistance, are exempt if a person is of Age Pension age or over.<sup>21</sup> Similar exemptions apply for certain *Veterans' Entitlement Act 1986* (Cth) and war-time compensation payments.<sup>22</sup>

7.16 In the Issues Paper, the ALRC asked if tax exemptions for social security payments affect mature age participation in the workforce.<sup>23</sup> Several stakeholders considered that these tax exemptions may deter workforce participation. COTA considered that they 'probably act as a disincentive to move from income support to paid employment'—however it considered that this should be ameliorated by the July 2012 increase to the tax-free threshold.<sup>24</sup> The Superannuated Commonwealth Officers' Association Inc considered that this disincentive may particularly affect mature age carers.<sup>25</sup> The Australian Industry Group stated that exemptions 'generally raise disposable income and reduce the imperative to earn income'.<sup>26</sup>

7.17 The Tax Review recommended that, to improve simplicity, all income support and supplementary payments should be tax exempt.<sup>27</sup> It further stated that taxing these payments can interfere with their main objective 'to increase poor households' real income'.<sup>28</sup>

## Tax offsets

7.18 Tax offsets directly reduce the amount of tax a person must pay.<sup>29</sup> They are subtracted from the tax calculated on a person's taxable income.<sup>30</sup> Tax offsets effectively increase the returns from work and arguably reduce disincentives to keep working.<sup>31</sup> In the Issues Paper, the ALRC asked whether tax offsets might be improved

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17 Assessable income consists of ordinary and statutory income: *Income Tax Assessment Act 1997* (Cth) s 6-1(1).  
 18 Ibid s 6-15(2); 6-20(1).  
 19 Ibid ss 52-5 to 52-40.  
 20 Ibid s 52-10.  
 21 Ibid s 52-15.  
 22 Ibid s 768-105.  
 23 Question 7.  
 24 COTA, *Submission 51*.  
 25 Superannuated Commonwealth Officers Association, *Submission 14*.  
 26 It also stated that exemptions may raise EMTRs: Australian Industry Group, *Submission 37*.  
 27 The Treasury, *Australia's Future Tax System: Final Report* (2010), rec 4.  
 28 Ibid, pt 2, vol 1, 28.  
 29 The term 'tax offset' is a generic term used in the *Income Tax Assessment Act 1997* (Cth) to describe what in *Income Tax Assessment Act 1936* (Cth) are called 'rebates' and 'credits'.  
 30 *Income Tax Assessment Act 1997* (Cth) s 4-10. In contrast, a deduction is subtracted from assessable income in calculating the taxable income on which tax is payable.  
 31 See: The Treasury, *Australia's Future Tax System: Retirement Income Consultation Paper* (2008), 37.

to encourage mature age workforce participation, and whether their removal—as recommended by the Tax Review—would create disincentives for mature age workforce participation.<sup>32</sup>

7.19 A number of tax offsets are available for mature age persons, depending on their particular circumstances.<sup>33</sup> These tax offsets have been subject to changes in 2012, as described below.

- The Senior Australians Pensioner Tax Offset was introduced on 1 July 2012. Previously, this was comprised of two separate offsets: the Pensioner Tax Offset and the Senior Australians Tax Offset.<sup>34</sup>
- In the 2012–13 Budget, the Australian Government announced it would phase out the Mature Age Worker Tax Offset for taxpayers born on or after 1 July 1957.<sup>35</sup>
- The Low Income Tax Offset has been reduced as the Australian Government has more than tripled the tax-free threshold.<sup>36</sup>

7.20 Most stakeholders commenting on this issue did not consider tax offsets an effective incentive for mature age workforce participation. National Seniors Australia commented that

The complexity and consequent lack of transparency of the taxation system inhibit the effectiveness of such offsets as incentives. An incentive that is not understood as such is not an incentive.<sup>37</sup>

7.21 Olderworkers stated that amounts are so small they would have little if any impact on decisions about work.<sup>38</sup> ACCI pointed out that the effect of the tax offset is experienced ‘in an ex-post manner—well after the event and beyond the time for implementing remedies or adjustments from a tax planning perspective’.<sup>39</sup>

7.22 In relation to the changes to the tax offsets and the low-income threshold, the National Welfare Rights Network commented that these are well-targeted and should ‘simplify the interaction that some older people have with the taxation system’. It argued that tax should be based on income rather than age, and that removing mature

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32 Issues Paper, Question 8.

33 For further information about these offsets, see the Issues Paper at [63]–[66].

34 *Clean Energy (Tax Laws Amendments) Act 2011 (Cth)* sch 3.

35 Australian Government, *Budget 2012–13: Budget Paper No. 2 (2012)* <www.budget.gov.au> at 3 September 2012, Revenue Measures. The Treasury has released exposure draft legislation and explanatory material for public comment in relation to the phase-out. Submissions closed on 17 August 2012: ‘Changes to Phase Out the Mature Age Worker Tax Offset’, The Treasury, *Website* (2012) <www.treasury.com.au> at 3 September 2012.

36 *Clean Energy (Tax Laws Amendments) Act 2011 (Cth)* sch 1; *Clean Energy (Income Tax Rates Amendments) Act 2011 (Cth)* sch 1.

37 National Seniors Australia, *Submission 27*.

38 Olderworkers, *Submission 22*.

39 Australian Chamber of Commerce and Industry, *Submission 44*.

age persons from the taxation system is ‘unfair on younger taxpayers and is financially irresponsible’—particularly given the ageing Australian population.<sup>40</sup>

7.23 The changes to tax offsets, and the raising of the tax-free threshold, are consistent with the Tax Review recommendation that tax offsets should be removed as separate components of the system and incorporated into the personal income tax rates scale.<sup>41</sup>

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40 National Welfare Rights Network, *Submission 50*.

41 The Treasury, *Australia's Future Tax System: Final Report* (2010), rec 5.