The government will need to review the level of the tax-free threshold periodically to maintain a relationship between the tax and transfer systems that has the simple and transparent character of this proposal.

**Tax offsets**

Tax offsets provide a mechanism for delivering lower net taxes to taxpayers with particular characteristics or types of income. However, the design differences in the large number of tax offsets add significant complexity to the tax system. People’s interactions with the tax system would be greatly simplified by rationalising the number of offsets. This would also provide a simpler and more transparent marginal tax rate structure.

**Tax offsets reduce the transparency of the tax system**

Tax offsets\(^7\) are used in the tax system for a number of purposes:

- to provide concessional tax treatment for some forms of income over others — for example, employment termination payment tax offsets;

- to provide concessional tax treatment of income received by particular groups of taxpayers relative to others — for example, the senior Australians tax offset (SATO); and

- to reduce interactions between taxable transfer payments and the tax system — through the beneficiary tax offset (BTO) and the pensioner tax offset (PTO).

At present there are more than 40 tax offsets, with different design features and impacts on people. Non-refundable tax offsets reduce the amount of tax that is payable on an individual’s taxable income by the dollar value of the offset. The full amount of these offsets can only be utilised where there is sufficient tax liability — if the offset is larger than the person’s tax liability no refund is available. Refundable tax offsets provide the full amount of the offset to the individual regardless of tax liability (that is, they can reduce tax to zero and create a refund).

The combination of all offsets, with their different interactions and eligibility criteria, contributes significantly to complexity in the tax system. Rationalising offsets could make the system simpler and reduce compliance costs. Many of the objectives of the current offsets could be (or have already been) achieved more effectively if delivered through transfer payments, other government spending, or through direct remuneration.

Some tax offsets are structural — that is, they alter the personal income tax rates scale for the majority or a large number of taxpayers. For example, in 2009–10 the low income tax offset (LITO) of $1,350 increases the effective tax-free threshold to $15,000 and changes the effective marginal tax rates for people with incomes between $30,000 and $63,750.

Most other offsets provide concessional treatment to a smaller group of people in specific circumstances. As concessional tax offsets are usually delivered on assessment, they generally do not deliver assistance to taxpayers at the time that the relevant expenses are

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\(^7\) Known as tax rebates in the *Income Tax Assessment Act* 1936.
incurred, are not transparent because they are not directly related to the incurring of the expenses, and they are generally targeted only at those people who have a tax liability.

The objectives of the current set of offsets could be achieved more simply and effectively if they were rationalised in the following way:

• Structural offsets (such as the LITO, SATO, PTO and BTO) should largely be removed. A higher tax-free threshold and adjustments to the personal income tax rates scale would facilitate this.

• Concessional offsets, which have in many cases been replaced by direct transfer payments or other government spending, should in most cases, be removed from the tax system. Exceptions should apply where the dependant is unable to work due to disability or carer responsibilities, or either the taxpayer or dependant has reached Age Pension age.

Findings

Structural tax offsets alter the personal income tax rates scale for a large number of taxpayers and create complex interactions between the tax and transfer systems. The assistance provided by structural tax offsets would be more simply and transparently delivered through explicit marginal tax rates.

Concessional tax offsets provide a mechanism for delivering lower net tax rates to taxpayers with particular characteristics. However, assistance provided in this way is not transparent, timely or well targeted.

Medicare levy complicates personal income tax

While the Medicare levy is designed to help fund Medicare expenditure, it only partially funds Medicare, which in turn constitutes only a fraction of total government health spending. Of the $71.2 billion spent on health by Australian, State and local governments in 2007–08, only $7.4 billion was funded by the Medicare levy. In June 2009 the National Health and Hospitals Reform Commission (NHHRC) recommended that the levy be increased by 0.75 percentage points to finance its proposed Denticare scheme (NHHRC 2009).

The Medicare levy raises the marginal tax rate for most Australian residents by 1.5 percentage points. However, the levy does not apply to all taxpayers and it interacts with the marginal tax rates in complex ways, creating high effective tax rates at some income levels.

A complex set of low-income phase-in arrangements operates to provide an exemption from the Medicare levy for people without a tax liability (treating couples and singles differently). The complexity of these arrangements and the income levels at which they are phased in make it difficult to avoid stacking of tax rates and withdrawal rates.

In addition, many people are exempt from paying the levy based on their personal circumstances. For example, members of the Australian Defence Force and non-residents are exempt. As a result of the phase-in and exemption arrangements, in 2007–08 only 75 per cent of the 11.4 million taxpayers with a gross tax liability paid the levy.
The levy may send a misleading message to taxpayers about the cost of health spending. This may encourage inconsistent demands for more public funding of health care combined with an expectation that this can be absorbed without higher rates of tax.

The Medicare levy should be removed and incorporated into the personal income tax rates scale. This would simplify the tax system and remove potentially misleading messages to taxpayers about the cost of health spending.

However, to increase the transparency of the costs of health, a share of revenue raised from personal income tax could be allocated to health expenditure. This allocation could be made whether or not the funds were hypothecated formally to health. Total government health spending accounted for around 56 per cent of personal income tax revenue in 2007–08 (based on tax revenue of $126.1 billion), increasing to 62 per cent in 2008–09 (based on estimated tax revenue of $125.8 billion). This could be applied as a proportion of the net tax payable by an individual. This option would be simpler and raise revenue on the more efficient personal income tax base.

**Medicare levy surcharge and private health insurance**

To increase the take-up of private health insurance, the Medicare levy surcharge requires individuals with an income for surcharge purposes over $73,000 and families with a combined income for surcharge purposes over $146,000 (increased by $1,500 for each dependent child after the first) in 2009–10 to pay an additional 1 per cent tax on their taxable income (including reportable fringe benefits) if they do not have complying health insurance for themselves and all their dependants. The singles threshold is indexed to AWOTE and increased in $1,000 increments (rounded down). The threshold for families is double the singles threshold. While the surcharge is designed to be entirely avoidable (by purchasing the required insurance cover), it was levied on 725,000 individuals and raised revenue of around $450 million in 2007–08.

As it currently operates, the Medicare levy surcharge is not ideal. Although levied on individuals, it is calculated on a family basis (by considering the presence of a spouse and the number, age and study status of any children). This means that the surcharge is levied on a high-income individual with insurance whose spouse does not have insurance. This complicates the system and makes compliance more difficult. It also creates spikes in EMTRs as it applies to every dollar of taxable income, including reportable fringe benefits, once the relevant income threshold is exceeded (rather than only the amount in excess of the threshold). The name of the surcharge is also misleading as it is not related to the Medicare levy and does not reflect its link with private health insurance. As a result, it should be relabelled to reflect this link.

The surcharge is closely linked with the private health insurance offset as part of a package of government polices aimed at increasing the take up of private health insurance. The offset is also problematic as it can be claimed using multiple mechanisms, including through the tax system, making the system unnecessarily complex and costly.

**Finding**

Tax arrangements relating to private health insurance, including the Medicare levy surcharge and the private health insurance tax offset, are unnecessarily complex.
Reform directions

**Recommendation 5:**
The Medicare levy and structural tax offsets — the low income, senior Australians, pensioner and beneficiary tax offsets — should be removed as separate components of the system and incorporated into the personal income tax rates scale. If a health levy is to be retained, it could be applied as a proportion of the net tax payable by an individual.

**Recommendation 6:**
To remove complexity and ensure government assistance is properly targeted, concessional offsets should be removed, rationalised, or replaced by outlays.

(a) The existing dependency offsets should be replaced with a single dependant tax offset where one of the following circumstances apply:

- the dependant is unable to work due to disability or carer responsibilities; or
- either the taxpayer or dependant has reached Age Pension age.

(b) The zone tax offset should be reviewed. If it is to be retained, it should be based on contemporary measures of remoteness.

(c) The mature age worker, employment termination payment, overseas civilian, entrepreneurs’ and notional tax offsets should be removed (see Annex A1). The education tax refund should be replaced as part of the single family payment, but as a back-to-school (lump-sum) amount.

(d) The overseas forces tax offset should be replaced by adjusting remuneration to maintain net incomes.

(e) Averaging tax offsets for primary producers, the offset for ‘special professionals’ and the lump sum payment in arrears tax offset should be retained to minimise the extent to which the timing of such income influences tax liability (see Annex A1).

**Recommendation 7:**
Consistent with the recommendations of the National Health and Hospitals Reform Commission:

(a) The medical expenses tax offset should be removed following a review of the scope and structure of health safety net arrangements.

(b) The Medicare levy surcharge and assistance for private health insurance should be reviewed as part of the package of tax and non-tax policies relating to private health insurance. The Medicare levy surcharge lump sum payment in arrears tax offset should be retained if the Medicare levy surcharge is retained (see Annex A1). Assistance, if retained, for private health insurance should be provided exclusively as a direct premium reduction.
**Structural offsets**

The low income tax offset (LITO)

The LITO is the mechanism that changes the tax-free threshold for the largest number of people, 6.8 million in 2007-08. This number will increase as the LITO rises as a result of legislated tax cuts. The full amount of LITO is available to individuals with taxable income up to $30,000, and the amount of LITO available is then reduced at the rate of four cents in the dollar. In 2009-10, the LITO has the same effect as increasing the tax-free threshold to $15,000 for those with incomes up to $30,000, increasing the 15 per cent marginal tax rate to 19 per cent (plus 1.5 per cent Medicare levy) for individuals with incomes between $30,001 and $35,000, and increasing the 30 per cent marginal tax rate to 34 per cent (plus 1.5 per cent Medicare levy) for those with income between $35,001 and $63,750 (the point at which the LITO is completely withdrawn).

The LITO not only increases the tax-free threshold, but also increases marginal tax rates at higher incomes (see Chart A1–12). As a result, many taxpayers with taxable income up to $80,000 face an effective marginal tax rate different to that set out in the personal income tax rates scale. For example, the only taxpayers who face a 30 per cent effective marginal tax rate (excluding the Medicare levy) in 2009–10 were those who earn between $63,751 and $80,000.

![Chart A1–12: Impact of the LITO on personal income tax rates 2009–10](image)

**Chart A1–12: Impact of the LITO on personal income tax rates 2009–10**

Note: Does not include Medicare levy.
Source: Treasury estimates.

The LITO should be incorporated into the personal income tax rates scale, both for reasons of transparency and to retain the progressivity of the personal income tax rates scale. This change would also make the benefit of the LITO fully available through the pay as you go withholding rates scale, rather than half through withholding and half on assessment, as is currently the case.

**Senior Australians tax offset (SATO)**

The SATO increases the effective tax-free threshold for people of Age Pension or Veterans Service Pension age. In 2006–07, approximately 623,000 people claimed the offset at a cost of
$1.1 billion. In 2010–11, the SATO, when combined with the LITO, will provide an effective tax-free threshold of $30,685 for singles and $26,680 for each partner in a couple. The SATO phases out (at the rate of 12.5 cents per dollar) for income above these thresholds and will be completely phased out once income reaches $48,525 (singles) and $39,496 (for each member of a couple not separated by illness). SATO amounts ($2,230 for singles and $1,602 for each member of a couple not separated by illness) are not indexed. Unused amounts of SATO can be transferred between partners up to the point where the maximum combined offset amount has been used.

The SATO should be removed, in conjunction with the Review’s recommendations that the tax-free threshold be raised substantially and that pensions and benefits be made tax-exempt. As a transitional mechanism, it should be replaced with an offset that takes into account the new personal income tax rates and thresholds and delivers a similar effective tax-free threshold. In light of the increase in the number of Australians accessing tax-free superannuation benefits, and a higher tax-free threshold, the tax concession provided by the new offset should be reduced over time.

**Pensioner tax offset (PTO)**

The PTO was introduced to ensure that pensioners and some allowees on maximum rates of payment do not incur a tax liability. The PTO is available to recipients of specified payments made under the *Social Security Act 1991* and *Veterans’ Entitlements Act 1986*. In 2008–09, the PTO was $2,240 for singles, $2,086 for partners in a couple who had to live apart due to illness or because one partner was in a nursing home, and $1,699 for each partner in a couple not separated by illness. The PTO, when combined with the LITO, provides an effective tax-free threshold of $25,298 for singles and $21,691 for each partner in a couple not separated by illness. In 2006–07, approximately 294,000 people claimed the offset at a cost of $459 million.

As the LITO has increased, there has been no offsetting downward adjustment to the PTO or SATO. This has pushed up the effective tax-free threshold delivered by the combination of PTO, SATO and LITO. As a result, most pensioners, whether full- or part-rate, no longer pay any tax on their combined pension and private incomes.

The PTO should be removed, in light of the recommendations to exempt all transfer payments from tax and increase the tax-free threshold. Pensioners of Age Pension age would have access to the transitional offset outlined in the SATO section above.

**Beneficiary tax offset (BTO)**

The BTO ensures that recipients of prescribed government payments such as allowances, drought assistance payments and wage supplements following disasters do not pay tax on the benefit or allowance component of their income. In 2006–07, approximately 279,000 people claimed the offset at a cost of $130 million.

The BTO should be removed, in light of the recommendations to exempt all transfer payments from tax and increase the tax-free threshold.
Concessional tax offsets

Dependency tax offsets

Concessional tax arrangements for dependants have been a feature of the tax system for a long time and were generally introduced at a time when spouses (and other dependants) typically depended on a main breadwinner and full-time work was the norm. There are five dependency tax offsets, which provide different levels of tax concessions to taxpayers depending on whether they support:

- a spouse who has a very low income;
- an invalid relative who has a very low income;
- a child who is not employed, but is undertaking (unpaid) work as a housekeeper in the taxpayer’s house;
- the engagement of a housekeeper to care for a child under 21 years, invalid relative or spouse receiving Disability Support Pension; or
- a dependent parent or parent-in-law who has a very low income.

The multiple dependency offsets complicate the tax system and are withdrawn from a low level of dependant’s income. This can affect participation incentives and is generally only appropriate where there is less concern about the impact on participation of the dependant; for example, for dependants unable to participate due to invalidity, or for people over Age Pension age.

The dependency offsets should not be provided where the dependant is able to seek work, because in this situation the offset acts as a work disincentive. The offsets should be more narrowly focused on taxpayers supporting either a dependant who is unable to work due to disability or carer responsibilities or where the taxpayer or dependant has reached Age Pension age.

Other concessional offsets

Several other tax offsets are designed to influence behaviour. In some cases these would no longer be necessary as a result of recommended changes to the personal income tax rates scale or because assistance is already provided through the transfer system. For example, the mature age worker tax offset was intended to provide people over 55 years with an incentive for continued workforce participation. However, the recommended increase in the tax-free threshold provides a more transparent and effective participation incentive for these people.

As a general principle, offsets should be limited to circumstances where the assistance cannot be provided effectively through the transfer system or other government spending. Further detail on existing concessional offsets and recommended reforms is presented in Annex A1.

Private health insurance tax offset

The Australian government currently subsidises private health insurance premiums based on a person’s age through three mechanisms: a direct premium reduction, a reimbursement from Medicare Australia, or a tax offset. Most people claim the rebate as a direct premium reduction, with around 96 per cent of private health insurance subsidies claimed through
premium reductions and Medicare Australia and around 4 per cent claimed through the tax system. In 2008–09, total expenditure on the private health insurance rebate was around $4 billion.

Providing multiple ways to claim assistance for private health insurance, including through the tax system, is unnecessarily complex and costly. If government wishes to subsidise private health insurance, assistance should only be provided as a direct premium reduction. This provides timely assistance, as it reduces the cost of insurance at the time it is paid, is simple to administer and is the most common way of claiming assistance.

Whether or not this subsidy is means tested requires a balancing of equity and complexity considerations. Means testing would help ensure this assistance is directed to those who need it most. On the other hand, it would require people to estimate their annual income when they receive assistance and then reconcile the assistance they receive against their actual income at the end of the income year. This would create a risk that inaccurate estimates of income would create debts. Means testing arrangements would also increase administrative complexity for policy holders, insurance providers and the ATO.

The National Health and Hospitals Reform Commission’s (NHHRC) final report recommended that the Australian government ‘commits to explore the design, benefits, risks and feasibility around the potential implementation of health and hospital plans to the governance of the Australian health system’ (NHHRC 2009). This would include examining the potential role of private health insurance alongside health and hospital plans including examining any changes to the Australian government’s ‘regulatory, policy or financial support for private health insurance’ (NHHRC 2009). As a result, tax arrangements for private health insurance, including the Medicare levy surcharge and the private health insurance tax offset, need to be assessed in light of an overall review of this sector. In keeping with this, the Review has only assessed the operation of these mechanisms in relation to the tax and transfer systems. It has not assessed the role, purpose and funding of private health insurance.