Tax Facts

A knowledge-based series by the Tax and Transfer Policy Institute

Good Tax Policy: Tax Offsets or Tax Deductions?

Australia's tax system includes a wide range of tax offsets and tax deductions. But –what is a tax offset and how is it different to a deduction? Is one policy better than the other?

How are tax liabilities calculated for individuals?

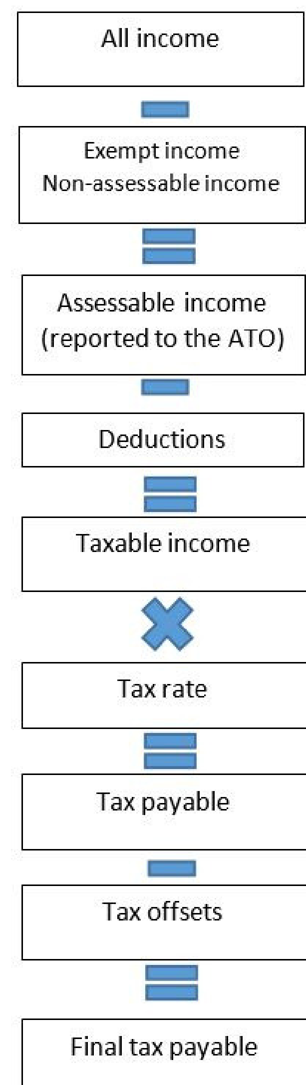
In order to understand the difference between tax offsets and tax deductions, it is useful to look at a simplified process of how an individual's tax payable is calculated in Australia.

As the flow chart on the right shows, the process starts with all income that an individual receives. From this total income, the first step is to subtract any income that the law has exempted from income tax. For example, this includes most superannuation pensions, any inheritance received and certain government payments such as the disability support pension.

Once the assessable income has been calculated, this value is reported to the Australian Taxation Office (ATO). The next step is to subtract any tax deductions. Tax deductions reduce assessable income by the value of any costs that the individual or entity incurred in order to earn their assessable income. For instance, a teacher can deduct the cost of any teaching materials that they bought using their own money. Similarly, someone with a home office can deduct the costs of running it, such as heating expenses or a computer.

After deductions, the remaining income is taxable. Taxable income is the income used to calculate the amount of tax that an individual or entity owes. For an individual, the taxable income is multiplied by the appropriate personal income tax rates to determine their tax payable.

Before the calculation is finished, any tax offsets are subtracted from the individual or entity's tax payable. The result is the individual or entity's final tax payable. This tax payable is the amount of money that an individual is required to pay the ATO that year.



What is the difference between a tax offset, credit and rebate?

The terms 'tax offset', 'tax rebate' and 'tax credit' are generally synonymous. All of these terms refer to a tax concession that directly reduces the tax that an individual or other entity has to pay. The ATO looks at an individual or entity's taxable income and works out how much tax is owed, then reduces that amount by the value of the tax offset. For example, if an individual has $10,000 in 'tax payable' at the end of the year, a $500 tax offset would directly reduce their tax payable by $500 to $9,500 (resulting in the final tax payable).

What is a tax deduction?

Tax deductions work differently from tax offsets. While a tax offset is subtracted directly from an individual or entity's tax payable, a tax deduction is subtracted from the individual or entity's assessable income, reducing their taxable income. This indirectly reduces the tax owed because taxable income is then multiplied by the tax rate to determine the tax payable. This means that a $100 tax deduction does not reduce *tax payable* by $100. Instead, it reduces the *taxable income* by $100, which is then multiplied by the individual or entity's tax rate to determine tax payable. If an individual's tax rate is 32.5 per cent, a $100 tax deduction would reduce their tax payable by $32.5.

Why do we have both tax offsets and tax deductions?

Tax offsets and tax deductions have different purposes within the tax system. Tax deductions are used to ensure that individuals or entities only pay tax on income they earn that exceeds the costs associated with earning that income. For instance, tax deductions mean that a cafe will not pay tax if the cost of running the business exceeds the revenue it collects from its coffee sales. Similarly, a teacher will not pay tax on income they used to purchase supplies for their classroom.

In contrast, tax offsets are used for a range of purposes. Some encourage certain activities, such as the Private Health Insurance Rebate, designed to encourage Australians to take out private health insurance. Others are used to support low income earners, encourage labour force participation or provide tax relief to certain groups, like older workers [1]. The Low Income Tax Offset, for example, provides a tax offset of up to $445 for individuals with incomes below $66,667 [see our tax fact on **LITO and the tax-free threshold**].

Which is better policy?

Neither offsets nor deductions are definitively better tax policy, since their appropriate use depends on a policy's objective. Tax deductions tend to provide a greater benefit to higher income earners compared to tax offsets of the same dollar amount. Australia's progressive income tax system imposes higher marginal tax rates on individuals as they earn higher incomes – in other words, each additional dollar they earn is taxed at a higher rate. For instance, someone with an income of $30,000 over the 2018-19 financial year in Australia pays tax at a rate of 19 cents for each extra dollar they earn, while someone earning $100,000 pays 37 per cent for each extra dollar. As a result, a $1,000 tax deduction is worth $190 for an individual earning $30,000, but is worth $370 for an individual earning $100,000 (see Table 1). By contrast, while tax offsets are worth the same, in dollar terms, to all individuals, they represent a higher share of lower incomes. For example, a $1,000 tax offset represents only 1 per cent of a $100,000 income, but 3.3 per cent of a $30,000 income.

Table 1. Impact of a $1,000 tax deduction and tax offset on tax owed

Assessable income	Tax owed	$1,000 tax deduction		$1,000 tax offset	
		Tax owed	Tax saved	Tax owed	Tax saved
(a)	(b)	(c)	(d) = (b) – (c)	(e)	(f) = (b) – (e)
(1) $100,000	$24,497	$24,127	$370	$23,497	$1,000
(2) $30,000	$2,242	$2,052	$190	$1,242	$1,000

As a result, tax deductions are regressive and may be better suited to compensating individuals and entities for work-related expenses. Tax offsets, in comparison, are progressive and provide greater (relative) tax benefits to low income earners. Both policies have the effect of lowering the amount of tax paid and influencing work incentives (see Gong & Breunig 2017) [2].

Refundable tax offsets

While tax offsets provide the same benefit to anyone who pays tax, they will not typically reduce a taxpayer's tax liability below zero. If an individual or entity has no taxable income at the end of the year, they will have no tax liability and may be unable to make use of any tax offsets. In light of this, refundable tax offsets are sometimes used. Refundable tax offsets work as negative income taxes. If an individual's tax liability is zero, or falls to zero because of tax offsets, any remaining value of the offset will be directly paid to the individual as a tax refund.

Refundable tax offsets are useful where the government wants to provide a benefit to an individual or entity who may have no tax liability. For instance, the Research and Development Tax Incentive, which is designed to incentivise research activity, is refundable for businesses with turnovers less than $20 million, thereby incentivising businesses without tax liabilities to conduct research.

[1] Breunig, R & Carter, A (2018), *Do earned income tax credits for older workers prolong labor market participation and boost earned income? Evidence from Australia's mature age worker tax offset*, TTPI Working Paper 15/2018, Tax and Transfer Policy Institute, Canberra.
[2] Gong, X & Breunig, R (2017), 'Child Care Assistance: Are subsidies or tax credits better?', *Fiscal Studies*, vol. 38, no. 1, pp. 7-48.

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