

**TAXING PERSONAL CAPITAL GAINS IN AUSTRALIA –
IS THE DISCOUNT READY FOR REFORM?**

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ABSTRACT

The 50 per cent Capital Gains Tax discount for individuals has become an entrenched feature of the Australian tax system, despite the fact that there was no promise of it being a permanent tax reform at the time of its introduction in 1999. Although the prospects for reform of the individual CGT in the immediate future appear limited, this paper compares a number of alternative options for taxing individual capital gains.

The paper argues that the CGT discount need not be considered a permanent tax change. The effects of the CGT discount should be subject to some empirical scrutiny in order to ascertain whether it is achieving its original objectives.

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I INTRODUCTION

One of the justifications for a capital gains tax (CGT) is that from an economic perspective, there is no difference between a capital gain and ordinary income. This is consistent with the principle of horizontal equity which considers that taxpayers in the same economic circumstances should incur the same tax liability and that the source of an accretion in wealth should not determine tax liability. CGT is also used to maintain the progressivity of the overall tax system and can therefore be justified according to vertical equity principles whereby a taxpayer's liability for tax should be determined by their economic ability to pay. Higher-income taxpayers receive a larger proportion of their income in the form of capital gains and they generally have a lower ratio of consumption to total income.¹ Taxation statistics for Australian individual taxpayers confirm that the majority of capital gains are realised at the highest levels of individual income. In the 2007-08 financial year, the proportion of total capital gains realised by Australian individual taxpayers with a taxable income over \$150,000 (taxpayers in the top 2.7 per cent of the income range) was 51.5 per cent.² In the same year, 72 per cent of net capital gains were realised by taxpayers with a taxable income of over \$75,000 (the top 12.9 per cent of taxpayers by reference to income).³

The Australian CGT was introduced in September 1985 to replace the limited system of taxing capital gains that had been in operation prior to this time, under sections 25A and 26AAA of the *Income Tax Assessment Act 1936*.⁴ The pre-1985 capital gains tax provisions proved to be ineffective by virtue of their limited application and there was consequently an incentive for taxpayers to re-characterise income as capital as a tax avoidance technique. The 1985 Capital Gains Tax acted as an integrity measure which improved vertical and horizontal equity and broadened the tax base.

In 1999, the Ralph Review of Business Taxation recommended a major reform to the individual CGT in the form of the 50 per cent CGT discount. The CGT discount permits specified taxpayers to include in their taxable income only 50 per cent of a capital gain from assets held for at least twelve months. This significant preference for capital gains, effectively a rate reduction, was justified by the Ralph Review on the basis that it would achieve a number of objectives including: enlivening and invigorating the Australian equities markets, stimulating greater participation by individuals and achieving a better allocation of Australia's capital resources.⁵ Given that rate preferences for CGT are damaging to the vertical and horizontal equity aspects of the tax,⁶ equity concerns may have been perceived as relatively unimportant by those who argued in favour of the introduction of the CGT discount.

The Ralph Review failed to explain either how the CGT discount rate of 50 per cent was determined or whether it was intended to be a permanent or temporary reform. Despite

¹ Jane Gravelle, *The Economic Effects of Taxing Capital Income* (The MIT Press, 1994)13.

² Australian Taxation Office, *Taxation Statistics 2007-08* (2010).

³ Ibid.

⁴ Capital Gains Tax is not strictly a separate tax in Australia, although it is commonly referred to as CGT.

⁵ Australian Treasury, 1999, *Review of Business Taxation, A Tax System Redesigned* 598.

⁶ Chris Evans, 'Curing Affluenza?: A Critique of Recent Changes to the Taxation of Capital Gains in Australia', (2000) 23(2) *University of New South Wales Law Journal* 299, 301.

this, the 50 per cent CGT discount has acquired a de facto permanent status due to the reluctance at the Federal Government level to change the rate of CGT discount. In 2010, the former Rudd Government ruled out any change to the CGT discount despite the recommendation of the Henry Review to lower the CGT discount rate to 40 per cent.⁷ The decision to rule out this reform was made in a relatively short period of time and it was not accompanied by detailed reasoning on why the reform was not considered to be viable. That a 40 per cent CGT discount was ruled out, rather than included in the reforms to be considered over the longer term, suggests that political considerations may have trumped tax policy considerations on that occasion.

Notwithstanding that there are a considerable number of arguments to be found for full rate CGT in the literature, in practice many tax jurisdictions offer tax preferences for capital gains, whether these are in the form of discounts, exclusions, exemptions or low rates relative to ordinary income. Although CGT rate preferences are also used in comparable tax jurisdictions such as the United States and Canada, they are unlikely to have their justification in rate competition, since capital is not highly mobile at the individual taxpayer level. The CGT discount has been criticised by some tax experts on the grounds that it is open to abuse and that its enactment was a retrograde tax policy move.⁸ The impetus for reforming the Australian individual CGT arises from these unaddressed criticisms of the CGT discount and from the fact that it may not be achieving its intended policy goals.

II THE NEED FOR REFORM

Deciding the rate at which to set a CGT is based on value judgments about equity.⁹ Despite the lack of a clearly articulated policy reason for the introduction of the Australian CGT discount, CGT rate preferences in general are usually justified based on arguments about increases in economic efficiency and entrepreneurship and the reduction in the lock-in effect that they may lead to. To date, there has been a lack of empirical evidence about whether the CGT discount has achieved such outcomes. The case for a lower rate of capital gains tax encouraging entrepreneurship and risk taking is a somewhat unconvincing one, given that there are a range of other factors that have an influence on decisions to invest. The CGT rate that will apply at the time a capital gain is realised is unlikely to be the most prominent influence on investment decisions, especially since CGT is not payable at the time the investment is made.

The CGT discount appears to be a poorly targeted measure for achieving entrepreneurship and risk-taking, since it does not favour riskier types of investments relative to other types of investments. Generally, a capital gains tax can encourage risk-taking by reducing the variation in return even though it also reduces expected return.¹⁰ Furthermore, the interaction of the CGT discount and interest deductibility can lead to distortions to efficiency. Deduction of interest at full, non-discounted rates, can act to encourage investment in assets that are economically inefficient insofar as they would

⁷ Ken Henry, *Australia's future tax system : report to the Treasurer* (2009) Commonwealth of Australia.

⁸ John Head and Richard Krever. 'Taxing capital income' (2007) 22 (2) *Australian Tax Forum*, 81,89.

⁹ Jon Kesselman, 'Capital Gains Taxation: Augmenting the Reform Report' (2005) *Tax Notes* 1687.

¹⁰ Gravelle, above n 1.

be loss making in the absence of tax considerations.¹¹ This significant efficiency cost appears to have been disregarded by policymakers when the decision was made to introduce the CGT discount.

In deciding how, or at what rate, to tax individual capital gains, all competing tax policy trade-offs should be considered and weighed up, including the distributional effects, rather than focusing on one particular effect of a change in the individual CGT regime. CGT is an important component of the overall personal income tax system and its operation and effects should therefore be evaluated in the context of the overall tax system.

Prior to the introduction of the CGT discount, one of the main focuses of the debate concerning the reform was the potential revenue effects. Revenue effects have been the cornerstone of the debate in the United States about CGT rate changes and they have been referred to extensively in the literature.¹² There is an argument that since revenue effects are only one aspect of CGT policy, they should not be given too much weight in determining whether a CGT rate preference is necessary. Reasons for this include that revenue effects cannot be predicted with certainty, they are unlikely to be large and a higher revenue yield can be better achieved through deemed dispositions on death rather than through CGT rate changes.¹³

The argument that the lock-in effect is an important factor in capital gains realisation decisions is based on an assumption that the rate of CGT is of high importance to investors. The lock-in effect may, in fact, not be important to the majority of capital gains realisation decisions and would not apply in forced realisation decisions or realisation for consumption. The literature identifies the lock-in problem as applying mostly to the sale of corporate shares and only to a small proportion of total sales.¹⁴

III ALTERNATIVE WAYS OF TAXING CAPITAL GAINS

A Restore Full Rate Capital Gains

The rate at which capital gains should be taxed is based on economic efficiency assessments and revenue effects.¹⁵ Taxing capital gains preferentially is essentially a compromise between creating incentives for saving and entrepreneurship against forgone tax revenue.¹⁶ Part of the Ralph Review's justification for the introduction of the

¹¹ Leonard Burman, 'Taxing Capital Gains in Australia: Assessment and Recommendations', in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Thomson Reuters, 2009) 113, 121.

¹² For example the view that there is little reason to believe that a reduction in capital gains tax would increase revenue can be found in Alan Auerbach, 'Capital Gains Taxation and Reform', (1989) 42 3 *National Tax Journal* 391. Whereas the view that reducing the tax on capital gains would increase tax revenue can be found in Martin Feldstein, Joel Slemrod and Shlomo Yitzhaki, 'The Effects of Taxation on the Selling of Corporate Stock and the Realizations of Capital Gains' (1980) 94 4 *Quarterly Journal of Economics* 790.

¹³ Richard Krever and Neil Brooks. *A Capital Gains Tax for New Zealand* (Victoria University Press for Institute of Policy Studies, 1990) 70-71.

¹⁴ *Ibid* 71.

¹⁵ Kesselman, above n 9.

¹⁶ *Ibid*.

50 per cent CGT discount was that CGT revenue would increase due to a reduction of the lock-in effect resulting in increased CGT asset realisations. However, this is a flawed justification for the CGT discount given that research from the United States has shown that a large reduction in the rate of capital gains tax is unlikely to be self-financing in the long run.¹⁷

One of the main weaknesses of the CGT discount is that it restores the incentive for taxpayers to engage in tax arbitrage behaviour, whereby income is re-characterised as capital. This type of tax arbitrage may have a negative impact on efficiency by lowering tax revenue and requiring governments to increase the rate of other distortionary taxes.¹⁸ It was a conclusion of the Ralph Report that the introduction of the CGT discount was intended to induce behavioural responses and that their size and revenue effects would be difficult to estimate.¹⁹ The implications of tax arbitrage should be part of a model that attempts to estimate the effects of capital gains taxation and such a model should, as much as possible, attempt to distinguish between the different motives for realising capital gains.²⁰ Although the encouragement of tax arbitrage is not an explicit objective of lowering the rate of capital gains tax, it can be a significant side-effect of such a measure. Under the CGT discount regime, a proportion of realised capital gains are due to an arbitrary conversion of income to capital rather than from an unlocking effect on gains that would not have been realised had the previous higher effective rate of CGT applied.

Another consideration that would apply to the reintroduction of full rate capital gains is whether to allow indexation of the cost base of CGT assets. The main argument in favour of indexation is that inflationary gains should not be subject to tax. However, the case for indexation is difficult to support if it only applies to one component of the tax system. Indexation can be considered more complex compared to a discount, but the latter is by no means an adequate substitute for indexation given that the rate of discount is not dependent on the timing of the realisation, except for the minimum holding period of twelve months. Whatever its merits, it would seem that the reintroduction of full rate capital gains in Australia is an unlikely event in the near future given the rejection of the Henry Review's recommendation to implement a minor change in the rate of CGT discount.

B Adopt the Recommendations of the Henry Review

The Henry Review recommended lowering the CGT discount to 40 per cent and applying this same rate of discount to other forms of non-labour income such as interest.²¹ Although this recommendation does not remove the incentive for taxpayers to re-characterise ordinary income as capital, it removes the preference for capital gains relative to other forms of non-labour income that currently exists.

¹⁷ Leonard Burman, *The Labyrinth of Capital Gains Tax Policy*, (Brookings Institution Press, 1999) 58.

¹⁸ Alan Auerbach & James Poterba, 'Capital Gains Taxation in the United States: Realizations, Revenue, and Rhetoric' (1998) 2 *Brookings Papers on Economic Activity* 595.

¹⁹ Parliament of Australia, Senate, 1999. Inquiry into Business Taxation Reform.

²⁰ *Ibid.*

²¹ Henry, above n 7.

Part of the Henry Review's rationale for the recommended 40 per cent discount rate was that it was intended to act as an adjustment for the effects of inflation.²² The use of a discount as a proxy for indexation achieves greater simplification with a rough approximation of an inflation adjustment, but still fails to correct for the benefits of long-term deferral of capital gains. The Henry Review also argued that a 40 per cent discount for the taxation of savings would counteract the tax wedge on future consumption that discriminates against those taxpayers who choose to save and reinvest and who incur a higher lifetime tax liability by doing so.²³

If the Henry Review recommendation of a reduced CGT discount were implemented it would provide an opportunity for an elasticity study to observe the effect of a CGT rate change on asset realisations and CGT revenue. Elasticity in the CGT context is the percentage change in capital gains realisations divided by the percentage change in the CGT rate. The literature distinguishes between elasticity of capital gains realisations due to permanent tax changes and the transitory response due to temporary tax changes.²⁴

For the purposes of an elasticity study, the current 50 per cent CGT discount could be considered a permanent tax rate since there was no lead time prior to its introduction, which would have allowed investors to time their realisation to obtain the best available effective tax rate. In the event that a new lower discount rate was announced along with a future date at which the 50 per cent CGT discount would cease operation, there would be some transitory effects to observe, related to taxpayers realising capital gains at a lower effective CGT rate now, with the knowledge that capital gains would be taxed at a higher rate in the near future. Distinguishing between permanent and transitory effects has important implications for measuring long term elasticity accurately. Behavioural responses that are due to transitory effects should not be included in the measurement of the permanent response to a CGT rate change.

The revenue effects of the Australian CGT discount could be evaluated by measuring elasticity using tax return data from a number of years preceding and following the introduction of the 1999 CGT discount. If the magnitude of the lock-in effect and elasticity as predicted by policymakers who oversaw the introduction of the CGT discount was found to be overstated, it would be appropriate for the recommendations of the Henry Review to be implemented as an incremental step toward further reducing the individual CGT discount.

C Introduce Taper Relief CGT

A taper relief system provides a progressive lowering in rates of CGT, or of the amount of capital gain to be included in assessable income, according to the length of time that an asset is held before disposal. Given that several different rates of CGT apply under taper relief, it is more complex than the current CGT regime. The introduction of a taper relief system would provide an opportunity for tax policymakers to increase the minimum holding period required for a capital gain to qualify for a discounted effective

²² Ibid.

²³ Ibid.

²⁴ Leonard Burman and William Randolph, 'Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data', (1994) 84(4) *The American Economic Review* 794.

CGT rate. An increase in the minimum holding period would address concerns about the current 50 per cent discount being too generous a preference in cases where the asset holding period is only marginally more than twelve months. There is currently an incentive for investors to time the realisation of capital gains shortly after twelve months of holding the asset. Notwithstanding the benefits of deferral applying to capital gains, timing a realisation in this manner under the current CGT regime ensures that the investor gains the maximum benefit of the 50 per cent discount.

A potential negative effect of a taper relief system is that it could increase the duration of the lock-in effect, depending on the elasticity of capital gains asset realisations. If the elasticity of capital gains asset realisations is high, taxpayers, being sensitive to CGT rates, would elect to retain their asset for the time required to qualify for the lowest possible CGT rate. Another argument against taper relief is that providing a higher level of discount according to the length of time an asset is held can be seen as counter to the benefits of deferral that apply to capital gains.

D Retain CGT Discount but Remove Minimum 12 month Holding Period

Most of the arguments in the literature for removing asset holding periods that are required for taxpayers to obtain the CGT rate preferences relate to economic efficiency concerns. The case for removing the 12 month holding period appears to relate more to liquid assets such as company shares rather than illiquid assets such as real property.

The inefficiency relates to decisions investors make about realisations; that is, although in some cases it may make economic sense for an investor to sell shares within a year of acquisition, they may instead choose to hold the asset for more than a year merely to qualify for the CGT discount. Notwithstanding the arguments about an asset holding period discouraging investors from changing their investment portfolios, the overall case for a 50 per cent CGT discount without a minimum holding period seems difficult to support given the high level of preferences that currently exist for capital gains.

The current 50 per cent CGT discount fails to achieve asymmetry between the treatment of capital gains and losses in a way that has not received a great deal of attention. This specific asymmetry problem occurs because taxpayers can realise capital losses on assets which have been held for more than 12 months, which can be offset against capital gains on assets that have been held for less than 12 months. A more symmetrical treatment would be to subject taxpayers' capital losses on assets held for more than 12 months to the same 50 per cent discount treatment as their capital gains. This measure would make no difference to the current tax treatment of offsetting capital losses against discount capital gains. However, it would result in a higher amount of CGT payable where the capital loss is used to offset a capital gain that is not eligible for the CGT discount, since the taxpayer would be required to only offset half their capital loss.

Although such a proposal would improve symmetry, it could have an adverse effect on efficiency. Although there is nothing unusual about an investor disposing of loss making assets within a 12 month period, under the proposed change, there would be an additional incentive for investors to do so, to be able to utilise the full amount of the capital loss. This added distortion is another argument for removing the minimum 12

month holding period. However, a disadvantage of a discount without a minimum holding period is that taxpayers would effectively be obtaining the benefit of a substitution for indexation even where the holding period was too short to justify receiving this.

Irrespective of any efficiency arguments for removing the minimum 12 month asset holding period for the CGT discount, this measure is unlikely to be adopted in Australia.

The benefits of deferral are such that any reform related to changing the 12 month holding period should be concerned with extending the amount of time that the asset must be held in order to qualify for the discount. In practice a taper relief scheme may be the best practical way of achieving this.

IV CONCLUSION

Much of the difficulty associated with determining the most appropriate way of taxing individual capital gains arises from the fact that CGT is a tax that can be avoided or postponed for a long period of time. Despite the benefits of deferral of capital gains being well documented in the literature, the current political environment is one where policymakers appear reluctant to implement changes to CGT that would result in higher effective CGT rates. The debate that preceded the introduction of the CGT discount was, in part, concerned with the effect that a CGT rate decrease would have on revenue. Unfortunately, those who advocated the 50 per cent CGT discount did not address the question of what was the most appropriate discount rate. How a CGT discount rate of 50 per cent was chosen is largely an unresolved question.

The reform of the CGT is a tax policy goal which appears to have been underestimated by some policymakers in terms of its importance as an integral part of the overall tax system. The introduction of the 50 per cent CGT discount was a piecemeal reform that effectively ignored some of the important effects on the overall personal income tax system. The large decrease in the effective CGT rate should not be accepted as a permanent tax policy change without verification and analysis of the predicted effects on the revenue and on the overall tax system. For example, the CGT discount combined with the deductibility of interest at full rates, can act to distort investment decisions by providing a tax preference for otherwise loss making investments. It would be remiss of tax policymakers to completely ignore this outcome as being not part of 'CGT reform' per se, since it was specifically the change to the effective CGT rate that gave effect to this anomalous outcome.

The tax policy merits of the CGT discount are questionable given the policy change was not justified according to traditional optimal tax policy criteria. The introduction of the CGT discount may have been more grounded in political considerations than good tax policy. Consequently, the optimal rate at which to tax capital gains is an unresolved question for tax policymakers in Australia and one which should be subject to further debate and scrutiny. For now, a decrease in the rate of CGT discount, as recommended by the Henry Review, should be part of the tax reform agenda.

The future CGT policy reform agenda should be aligned with the justifications for the introduction of the original Australian CGT in 1985. Reform of CGT related to changes in the rate of the CGT discount should be considered in view of the benefits of deferral that

apply to the taxation of capital gains. The deferral benefits reduce effective tax rates on capital gains compared to other forms of non-labour income.

There is an apparent need for an empirical study that determines the elasticity of capital gains realisations in Australia. Such a study would act to confirm or disprove the predicted revenue effects of the CGT discount, which appear to have been a strong influence on the decision to introduce the CGT discount. A review of the parliamentary debate prior to the introduction of the CGT discount demonstrates that policymakers deferred to the view that a rate reduction in CGT necessarily leads to an increase in revenue. If policymakers consider revenue effects important in determining the effective CGT rate, future policy decisions on capital gains tax reform should be influenced by empirical studies that use Australian data to determine what the revenue effects are rather than what they are expected to be. An Australian study on elasticity would further inform the debate on how to best tax individual capital gains.