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Reforming Australia's 50 per cent capital gains tax discount incrementally

Brett Freudenberg[*] and John Minas[**]

Abstract

This article considers concerns about Australia's capital gains tax (CGT) discount (providing generally for a 50 per cent discount on taxation of gains of resident taxpayers other than companies from disposal of assets held for more than 12 months) related to fiscal adequacy, and horizontal and vertical equity. We argue that, based on these concerns, there is a case for reform of the CGT discount. In considering reforms, there are two broad choices available to policy-makers. The CGT discount could be reformed by way of an incremental approach or, in the alternative, through its complete removal and replacement with new provisions. In this article, we argue that it may be more pragmatic to adopt the former approach. In the case of the CGT discount, an appropriate incremental reform would be to change the rate of the discount and introduce a non-cumulative annual CGT discount cap. Although there are arguments for abolishing the CGT discount and reverting to the taxation of capital gains at full marginal tax rates, this may be difficult to achieve in practice. The incremental approach has been used successfully in previous tax reforms in Australia and this type of reform does not preclude policy-makers from pursuing the taxation of capital gains at marginal tax rates as a longer-term policy goal. We argue that well-executed incremental reform can help avoid grandfathering of the former provisions and, in turn, avoid the complexity associated with such a rule.

Key words: capital gains tax, CGT, discount, tax reform, Australia

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[*] Professor, Griffith University, email: b.freudenberg@griffith.edu.au.
[**] Lecturer, Griffith University and Adjunct Lecturer in the Tasmanian School of Business and Economics, University of Tasmania, email: j.minas@griffith.edu.au.

1. Introduction

This article considers some of the concerns raised about the 50 per cent CGT discount in public discussion to date and the two possible broad approaches to its reform that have been identified in that discussion. Although there is a case for one of these approaches, namely abolishing the CGT discount, there is an argument that a more politically viable path to reform is by way of the other of the reform paths, involving an incremental approach.

The CGT discount has provided opportunities for tax sheltering and it has compromised tax system integrity,[1] horizontal equity, and vertical equity. Notwithstanding the problems with the CGT discount, this article sets out an argument for reducing the rate of the discount rather than abolishing it. It is argued that such incremental change to the CGT discount may constitute a pragmatic approach to reform. Although there is a case for a comprehensive approach to taxing capital gains, under which capital gains are taxed at full marginal rates, achieving this in the short term may be impeded by political considerations. In addition, if the CGT discount were abolished, policy-makers may decide to enact 'grandfathering' provisions to apply to assets taxpayers had acquired before the enactment of the law change. Australia's previous experience with grandfathering and CGT indicates that it increases tax system complexity.

The arguments made in the article to reform the CGT discount incrementally are not an endorsement of the CGT discount. Rather, they reflect the need for immediate incremental reform with the ultimate policy objective being the abolition of the CGT discount. The proposed reform can thus be characterised as a 'second best' policy recommendation.

After this introduction, section 2 of this article sets out some of the concerns about the CGT discount. In section 3 the potential problems related to the complete removal and replacement of the CGT discount are critically analysed and the alternatives considered. In section 4 consideration is given to the ways in which the CGT discount can be reformed to address many of the concerns raised. Conclusions and recommendations are set out in section 5.

2. Concerns

Specific concerns about the 50 per cent CGT discount include that it has a tax revenue cost, and that it compromises vertical equity, horizontal equity and tax system neutrality. Arguments for the CGT discount to ensure that inflationary gains are not taxed are unconvincing, given the imprecision of the discount as a proxy for inflation. The CGT discount compromises tax system integrity by creating an incentive for taxpayers to receive most of their income in the form of capital gains and, where possible, to re-characterise income receipts as capital gains. Each of these concerns is now discussed in turn.

2.1 Cost to tax revenue

The CGT discount is one of the most significant tax expenditures for the Australian government. For the 2015-16 tax year, the cost of the CGT discount was estimated to

[1] John Daley, Danielle Wood and Hugh Parsonage, *Hot Property: Negative Gearing and Capital Gains Tax Reform* (Grattan Institute, 2016).

have been AUD 6.2 billion.[2] It follows that the cumulative revenue cost over the nearly two decades that the CGT discount has been in operation is sizable.

The Ralph Review (which recommended the introduction of the CGT discount) predicted that there would a revenue positive or revenue neutral effect of the CGT reform package that was enacted in 1999–2000.[3] This prediction took into account tax revenue savings due to the 'freezing' of indexation of the cost base and the removal of five-year averaging.[4] The Ralph Review prediction was also based on assumptions about taxpayers increasing the amount of capital gains realised following the enactment of the discount. Notwithstanding that there is likely to be an increase in capital gains realisations following a tax rate reduction (or the enactment of the CGT discount), this does not guarantee an increase in tax revenue. Assuming there is no behavioural response to a CGT rate reduction, there will be a static revenue loss. There will only be a revenue increase if the realisations response is large enough in magnitude to compensate for the static loss.

In 1999 when the enactment of the CGT discount was considered, there was no empirical evidence to support the view that it would necessarily lead to an increase in revenue.[5] Moreover, a review of the literature from the United States would have cautioned policy-makers against predictions of a capital gains realisations response large enough in magnitude to increase CGT revenue following the enactment of the CGT discount. Recent empirical estimates of the capital gains realisations response imply that the 50 per cent CGT discount for personal taxpayers in Australia is likely to have been a revenue-losing policy.[6]

2.2 Equity

Concerns have been raised about the inequity of the CGT discount. The equity concerns relate to the established 'good' tax system characteristics of vertical equity and horizontal equity, as well as the more recent notion of 'age equity'.[7] The remainder of this section considers the three types of equity.

2.2.1 Vertical equity

Vertical equity requires that taxpayers with a greater ability to pay tax should pay more tax.[8] A specific feature of Australia's tax system that is designed to achieve vertical

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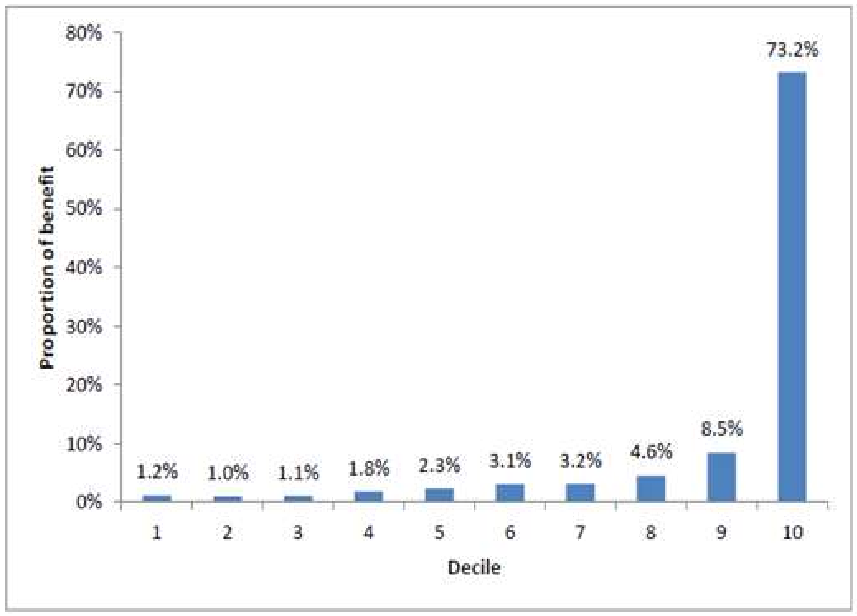
[2] Ibid 36.
[3] Review of Business Taxation (John Ralph, chair), *Review of Business Taxation: A Tax System Redesigned: More Certain, Equitable and Durable, Final Report of the Review of Business Taxation* (July 1999) (Ralph Review). Specifically, according to the Review, 698, Table 24.1, the projected revenue impact of the CGT reforms was an estimated net revenue gain of AUD 450 million for the years 2000-01 to 2004-05 inclusive.
[4] Ralph Review, above n 3, 725, Table 24.7.
[5] This, in part, relates to the fact that estimates of the realisations response could not be prepared in the absence of previous changes in the CGT rate.
[6] John Minas, Youngdeok Lim and Chris Evans, 'The Impact of Tax Rate Changes on Capital Gains Realisations: Evidence from Australia', (2018) 33(4) *Australian Tax Forum* 635.
[7] Although there is an absence of literature on age equity, the data discussed in this section of the article suggest that this concept may attract increased attention. To the extent that tax preferences are skewed towards a particular age demographic, it can be argued that the tax system is inequitable in terms of taxpayer age. This type of inequity is not the result of tax policies that are only available to particular age groups.
[8] Leonard E Burman, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed* (Brookings Institution Press, 1999) 3.

equity is the progressive marginal tax rate scale for resident individuals.[9] Notwithstanding these progressive tax rate scales, vertical equity is compromised by the operation of the CGT discount. Specifically, data on the net capital gains of individual taxpayers in Australia indicate that most of the benefit of the CGT discount is skewed towards high income taxpayers. Specifically, nearly three-quarters of the benefit of the CGT discount accrues to the top 10 per cent of taxpayers by household income.[10] The top 20 per cent of household incomes received 82 per cent of the CGT discount, whereas only 14 per cent of the CGT discount was accessed by the bottom 70 per cent of household incomes: Figure 1.[11]

Fig. 1: Distribution of CGT Discount by Household Income



Source: NATSEM, ATO (2014) *Taxation Statistics 2011-12*, updated to 2014-15

Source: Matt Grudnoff, *Top Gears: How Negative Gearing and the Capital Gains Tax Discount Benefit the Top 10 Per Cent and Drive Up House Prices* (The Australia Institute, 2015) 5.

Because of the skewed distribution of capital gains, a CGT rate lower than the tax rate on other forms of income distorts the progressivity of the tax system. A personal taxpayer at the highest marginal tax rate can face a significantly lower effective tax rate in years when they realise capital gains. Such inequity can lead to an increasing

[9] The Australian personal tax system for resident taxpayers has a tax-free threshold (a tax rate of zero) for those with a taxable income up to $18,200. The highest tax rate of 45 per cent applies taxable income amounts over $180,000. Tax rates of 19 per cent, 32.5 per cent and 37 per cent apply to various levels of taxable incomes in between these lowest and highest rate brackets. In addition to these statutory tax rates, taxpayers may be liable for levies and surcharges which increase overall tax liability.

[10] Matt Grudnoff, *Top Gears: How Negative Gearing and the Capital Gains Tax Discount Benefit the Top 10 Per Cent and Drive Up House Prices* (The Australia Institute, 2015) 5, citing estimates by the National Centre for Social and Economic Modelling (NATSEM): 73.2 per cent to the top ten per cent.

[11] Ibid: NATSEM estimates.

concentration of wealth, which has been described by Thomas Piketty as a marker of an 'endless inegalitarian spiral'.[12]

It is also arguable that vertical inequity is heightened due to capital gains generally only being taxed on realisation. Specifically, a taxpayer's wealth – and their ability to pay tax – increases where the value of their assets increases.[13]

2.2.2 Horizontal equity

Horizontal equity refers to the notion that taxpayers with the same economic wealth should be required to pay the same amount of tax.[14] The CGT discount breaches horizontal equity, given that it provides a tax preference for most taxable capital gains.[15] By contrast, other types of income do not receive this type of preferential tax treatment. Horizontal equity is important to a self-assessment tax system, since perceptions of unfairness can have an adverse effect on enforceability.[16] The horizontal inequity caused by the CGT discount relates to taxpayers with the same level of income incurring different tax liabilities because of their income including different proportions of discount capital gains.

The disparity between the preferential tax treatment of capital gains and the non-preferential treatment of other income is accentuated by the time value of money, given that capital gains are taxed on a realisation basis, whereas other income, such as wages, are taxed in the year they are derived.[17] Under a pure comprehensive income tax, capital gains would be taxed as they accrue and accrued capital losses could be used to offset all types of income, without restriction.

Notwithstanding the realisation basis of taxing capital gains, the CGT discount breaches horizontal equity, given that taxpayers with discount capital gains face a lower effective tax rate than taxpayers without capital gains.

2.2.3 Age equity

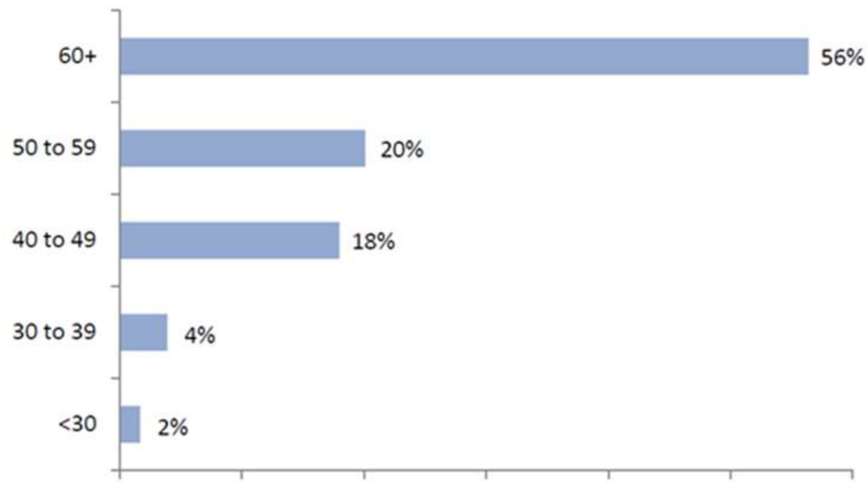
In addition to the established concepts of vertical and horizontal equity, another way to conceptualise equity in the tax system is according to the tax treatment of taxpayers in various age groups. This characterisation has gained attention recently, given that many previously available concessions in the tax system have been slowly eroded due to budgetary concerns. In some cases, the removal of a tax concession is accompanied by grandfathering provisions that can entrench the tax advantages of the repealed law. To the extent that older taxpayers have had increased opportunities to benefit from

[12] Thomas Piketty, *Capital in the Twenty-First Century* (Harvard University Press, 2013).
[13] Although some may argue that taxpayers with unrealised gains have a lesser ability to pay tax due to liquidity problems, it is clear from a review of the CGT events in the *Income Tax Assessment Act 1997* (Cth) that CGT liability can result from certain events that do not increase the taxpayer's liquidity.
[14] Claudio M Radaelli, 'Taxation Research as Political Science Research' in Margaret Lamb et al, *Taxation: An Interdisciplinary Approach to Research* (Oxford University Press, 2005) 85.
[15] Based on Australian Taxation Office, *Taxation Statistics 2014-15*, Table 1 Selected capital gains tax schedule items by entity, 2014-15 income year. It is estimated that discount capital gains were approximately 95 per cent of the capital gains of personal taxpayers in that year.
[16] Willard H. Pederick, 'Fair and Square Taxation for Australia' (1984) 19(6) *Taxation in Australia* 575.
[17] This is especially the case when one considers that under the PAYG-Withholding system, employers are required withhold income tax from wage and salary payments to employees.

longstanding tax preferences, the subsequent repeal and grandfathering of these preferences is, arguably, biased towards older taxpayers.

As indicated in Figure 2, individual taxpayers in the age group of 60 years and above benefit most from the CGT discount compared to taxpayers in younger age groups.[18] The higher proportion of capital gains realised by older taxpayers may reflect higher levels of accrued capital gains that have accumulated over a longer period of time compared to the younger age groups. Another factor that may influence the skewed distribution of capital gains by taxpayer age is the greater propensity to realise capital gains when income is lower.[19]

Fig. 2: CGT Discount by Age Group



Source: The Australia Institute, 'Briefing Note: Tax Concessions by Age' (15 February 2016) 2.

2.3 Inefficient investment decisions

Another concern about the CGT discount relates to the notion of tax neutrality. The potential for the tax system to unintentionally distort taxpayers' investment decisions is undesirable. Tax neutrality is an important principle of tax system design that requires neutrality in relation to taxpayer investment or consumption choices.[20] In instances of significant neutrality breaches, the tax system could impede or reduce the productive capacity of an economy.

Modern tax systems are far removed from the ideal models advocated in the public finance literature. One of the reasons for this is that governments may intentionally breach one of the tax policy criteria in the belief it will achieve desirable policy goals.

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[18] The Australia Institute, 'Briefing Note: Tax Concessions by Age (15 February 2016) 2.

[19] Typically, the incomes of some taxpayers in the 60 and over age group would be lower due their being in retirement.

[20] Some have argued that there is more than one concept of tax neutrality. One of the more prominent examples of an alternative definition is that tax neutrality is a description of tax provisions that conform to an ideal tax system. See Douglas A Khan, 'The Two Faces of Tax Neutrality: Do They Interact or Are They Mutually Exclusive?' (1990) 18(1) *Northern Kentucky Law Review* 1.

For example, tax neutrality can be breached by the introduction of tax concessions for expenditure on research and development to encourage greater expenditure. Such tax concessions may, however, provide incentives for aggressive tax planning.

Tax neutrality requires a tax to be judged according to the extent to which it influences the allocation of resources.[21] Taxes that do not interfere with the market allocation of resources are referred to as neutral.[22]

Increasingly, governments have acknowledged the importance of tax neutrality,[23] in some cases at the expense of equity.[24] Tax neutrality was discussed in the Asprey Report in Australia in the mid-1970s[25] and, more recently, its importance was further emphasised by the Ralph Committee.[26] The Henry Review has also reiterated the adverse effect that a departure from neutrality may have, noting that it 'sets up the potential for inefficient outcomes that can affect overall business productivity'.[27]

An example of a potential effect of the tax system on neutrality is the case of the Australian housing market. Some commentators have argued that there has been an overinvestment in housing, owing in part to tax preferences such as the CGT discount. Taxpayers contemplating investing in real property are likely to factor into their decisions the benefits of concessional CGT treatment, especially when rental yields are relatively low. On this point, an interview study with Australian rental property investors, conducted by Seelig et al, reported that, in most cases, respondents' decision to invest in rental properties was more strongly motivated by the prospect of capital gains rather than by the derivation of rental income.[28]

A supposed benefit of the CGT discount is that it encourages risk-taking by entrepreneurs, as it increases their after-tax return on selling a successful business.[29] Cunningham and Schenk are critical of capital gains preferences as incentives for risk-taking, because the preferences are untargeted and they provide incentives for non-risky CGT assets as well.[30] If the CGT discount is meant to encourage entrepreneurial activity,

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[21] Peter A Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems* (IBFD Publications, 1996) 8.
[22] Ibid.
[23] Steffen Ganghof, 'Adjusting National Tax Policy to Economic Internationalization: Strategies and Outcomes' in Fritz W Scharpf and Vivien A Schmidt (eds), *Welfare and Work in the Open Economy: Vol II Diverse Responses to Common Challenges in Twelve Countries* (Oxford University Press, 2000) 613; Miranda Stewart, 'The Mechanics of Taxing Entity Distributions: A Comparative Perspective' (paper presented at the Australasian Tax Teachers' Association Conference, Sydney, 1-3 February 2001) 4.
[24] Early in the 20th century the focus of tax policy appeared more directed to equitable concerns, with consideration as to whether the tax system operated fairly between taxpayers: Radaelli, above n 14.
[25] Taxation Review Committee (Justice Kenneth Asprey, chair), *Full Report* (31 January 1975) (Asprey Review) 16: 'Tax neutrality principle requires that the tax system should be neutral between alternative business or consumption choices; and in this way the impact of tax will not influence individual or business choices by distorting or altering the costs of alternatives'.
[26] Ralph Review, above n 3, 105.
[27] Australian Treasury, *Australia's Future Tax System: Consultation Paper* (10 December 2008) 153.
[28] Daley, Wood and Parsonage, above n 1, 24, citing Tim Seelig et al, *Understanding What Motivates Households to Become and Remain Investors in the Private Rental Market* Australian Housing and Urban Research Institute, 2009), http://www.ahuri.edu.au/publications/download/ahuri_20280_fr. The study explored the motivations of rental property investors through in-depth interviews with 30-40 investors in each of the study states of NSW, Victoria and Queensland.
[29] Daley, Wood and Parsonage, above n 1, 8-11.
[30] Noël Cunningham and Deborah Schenk, 'The Case for a Capital Gains Preference' (1993) 48(3) *Tax Law Review* 319.

it is a poorly targeted policy. This is notwithstanding that an entrepreneur's decision to invest in a new business would not necessarily be guided by the after-tax return on the event of the eventual sale of their business several years later.

Domar and Musgrave analysed the impact of tax on investor behaviour by reference to 'indifference curves',[31] and argued that increased risk-taking[32] is highly desirable and that 'a high degree of loss deduction is of vital importance'.[33] Stiglitz noted the limitations of the kind of analysis used in the Domar and Musgrave study, and concluded that 'even if preferential treatment of capital gains (encouraged greater risk-taking) effectively, it is not clear that preferential treatment of capital gains is the most desirable way of encouraging risk-taking'.[34]

If policy-makers sought to increase investment in riskier assets, they could develop a policy measure to replace the CGT discount that is much more targeted towards that objective. This could, for example, be by way of a tax incentive that requires assets to be used in business activities.[35]

There is little evidence in the literature about a CGT rate preference constituting an appropriate method for encouraging entrepreneurship and venture capital investments, given that it is a broad and untargeted way of encouraging such investments. According to Poterba, 'there is very limited evidence on the extent to which the supply of entrepreneurial activity responds to the relative tax burdens on capital gains and labor income'.[36]

2.4 Inflation

Prior to the enactment of the CGT discount in the 1999-2000 tax year, Australia provided for the indexation of the cost base of CGT assets held for more than 12 months, to ensure that inflationary gains were excluded from assessment.

While various arguments have been made for the tax system to allow for the indexation of the cost base of CGT assets, the CGT discount is difficult to justify on the basis that it is a means of ensuring that inflationary gains are untaxed. In most instances the CGT discount over-compensates taxpayers for the effects of inflation. This is especially the case for capital gains realised immediately after the 12-month qualifying period.[37] Furthermore, deductible interest expense invariably includes an inflation component

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[31] Evsey D Domar and Richard A Musgrave, 'Proportional Income Taxation and Risk-Taking' (1944) 58(3) *Quarterly Journal of Economics* 388, 408.
[32] Ibid 391: either by way of an investor reducing their total assets held in cash, or by way of a change from less to more risky investments.
[33] Ibid.
[34] Joseph Stiglitz, 'The Effects of Income, Wealth, and Capital Gains on Risk-Taking' (1969) 83(2) *Quarterly Journal of Economics* 263, 283.
[35] In comparison, the small business CGT provisions in Division 152 of the *Income Tax Assessment Act 1997* (Cth) are generally only available for 'active assets', being those used in the course of carrying on a business (s 152-40). Passive assets, such as those which are used principally to derive rental income are excluded: s 152-40(4)(e).
[36] James M Poterba, 'Capital Gains Tax Policy Toward Entrepreneurship' (1989) 42(3) *National Tax Journal* 375, 384.
[37] See John Minas, 'Taxing Personal Capital Gains in Australia – Is The Discount Ready for Reform?' (2011) 6(1) *Journal of the Australasian Tax Teachers Association* 65.

and the deductible amount of interest expense should be reduced if an inflation adjustment is made for the amount of capital gains subject to tax.

The justification for inflation adjustments for capital gains is tenuous, given that other forms of capital income, such as rental and interest income, receive no such inflation adjustment. For example, interest income generally includes compensation for inflation, as well as the real interest return. However, the full interest is assessed,[38] meaning the effective marginal tax rate can be much higher.[39] Furthermore, the argument that one type of assessable income within the tax system should be taxed on real rather than nominal terms, while others do not receive this treatment, is less than compelling. Since capital gains are taxed on a realisation basis and not as they accrue, the benefits of deferral can offset the impact of inflation. For an asset that has been held for several years prior to disposal, the burden of inflation is considerably less than for income that is taxed annually. The non-indexation of the cost base of capital gains assets appears relatively unimportant compared to the case for annual adjustments to personal income tax brackets for inflation. Notwithstanding that the Australian tax system currently lacks a system of annual indexation of personal income tax brackets, there was a time when this had a strong negative impact on vertical equity. On this point, Evans and Krever noted that bracket creep, in combination with increased tax evasion and avoidance in the 1980s contributed to 'extraordinary marginal tax rates imposed on persons with very ordinary weekly earnings'.[40]

2.5 Policy clarity

Part of the reasoning for the introduction of the CGT discount was the view that it could stimulate capital markets and make the Australian regime more internationally competitive.[41] It has also been argued that the CGT discount was intended to reduce the bias that income tax may create against savings and investment,[42] particularly the bias towards asset retention.[43] In theory, a greater liquidity of capital assets could promote more efficient asset management and greater capital mobility.[44]

Nevertheless, the CGT discount creates its own biases in relation to saving and investment. This is because assets for which most of the return is in the form of capital gains are afforded preferential treatment by the tax system in comparison to assets for

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[38] The full interest return is known as the 'nominal interest rate', which includes the inflation compensation as well as the real interest rate.
[39] See the illustration provided in Australia's Future Tax System Review Panel (Dr Ken Henry, chair), *Australia's Future Tax System: Report to the Treasurer* (December 2009) (Henry Review) Pt 2, Vol 1 Detailed Analysis 67.
[40] Chris Evans and Richard Krever, 'Tax Reviews in Australia: A Short Primer' in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Thomson Reuters, 2009) 3, 7. Evans and Krever also referred to the legislation which, between 1976 and 1979, provided an inflation adjustment for trading stock. At the time it was in operation, these legislative rules in the *Income Tax Assessment Act 1936* Div 3, Subdiv BA were another example of policy which offered an inflation adjustment to one feature of the tax system, while ignoring the effect of inflation on others. For a detailed discussion of Australia's experience with a tax indexation scheme from 1978 to 1981, including the observations from the Asprey Report and Mathews Report, see Chris Terry, *Personal Income Tax Indexation* (Australian Tax Research Foundation, 1983).
[41] Ralph Review, above n 3, 14.
[42] Daley, Wood and Parsonage, above n 1, 8.
[43] Sam Reinhardt and Lee Steel, 'A Brief History of Australia's Tax System' (2006, Winter) *Economic Roundup* 1, 12.
[44] Ibid.

which a larger part of the return is in the form of income. The case for the CGT discount on grounds of capital mobility is somewhat tenuous. This is because non-resident taxpayers are subject to limited assessment on Australian capital gains in comparison to resident taxpayers. Furthermore, the broad effect of Australia's double tax agreements is that many foreign-source capital gains of resident taxpayers would be subject to tax in Australia.

The Ralph Review's forecast of a CGT revenue increase appears to have been the central rationale for the enactment of the CGT discount. However, in the absence of empirical evidence on the capital gains realisations response it cannot be assumed that a reduction in the CGT rate will lead to an increase in revenue from CGT. Nonetheless, at the time the CGT discount was being contemplated in 1999, some of the debate on the relationship between CGT rate reductions and revenue was carried out in overly simplistic terms and in a way that reflected an incomplete understanding from some policy-makers.[45] If the capital gains realisations response is small or moderate in magnitude it may fail to compensate for the static revenue loss from the lower CGT rate, and the overall effect of the CGT rate cut would be a revenue loss. The most recent estimates of the capital gains realisations response for Australian personal taxpayers, imply that the CGT discount has caused a net loss of tax revenue.[46]

Although calculating a discount capital gain can be simpler than calculating a capital gain under the indexation method, the CGT discount can still increase tax system complexity. Part of the complexity associated with CGT rate preferences arises from legislators seeking to counteract avoidance techniques such as the re-characterisation of income into capital. This may include the enactment of new legislative provisions as a means of bringing CGT events that were not originally contemplated into the tax base.[47] An example is the legislative complexities encountered in the interaction of the CGT discount provisions of Division 115 of the *Income Tax Assessment Act 1997* with rules relating to specific forms of entity, such as the trust provisions.

Evans established that CGT compliance costs are significant in Australia; this applies in relation to the amount of tax payable, the amount of revenue collected, and the compliance costs of other taxes.[48] Furthermore, the compliance costs of the CGT regime are a concern to practitioners and there is a serious problem of under-billing for CGT work. In that regard, almost one in two practitioners revealed that they could not recover the full costs of their professional work on CGT from clients, with the estimated average amount of under-billing at 30 per cent.[49]

It is of concern that the policy justification for the CGT discount in 1999 lacked clarity and coherence. Ultimately, it appears that the desired revenue effects were the overarching policy justification. Importantly, it can be argued that the CGT discount has

[45] For example, Senator Gibson stated, in reference to his understanding of the US experience on the revenue effect of CGT rate changes, that 'when the capital gains tax was increased, revenue went down; when capital gains tax was decreased, revenue went up' (Commonwealth Parliamentary Debates, Senate, 29 November 1999, 10,894). This is not a complete or accurate summary of the effects of CGT rate changes on revenue.
[46] Minas, Lim and Evans, above n 6.
[47] It is the case that the number of CGT events contained in the *Income Tax Assessment Act 1997* (Cth) has expanded over time.
[48] Chris Evans, *Taxing Personal Capital Gains: Operating Cost Implications* (Australian Tax Research Foundation, 2003).
[49] Ibid.

contributed to negative outcomes that policy-makers at the time did not fully contemplate.

2.6 Re-characterisation of receipts

The CGT discount can provide an incentive for taxpayers to re-characterise revenue receipts as capital receipts. In the US context, Auerbach noted that much of the capital gains realisation activity represents tax arbitrage, characterised by taxpayers realising capital gains and incurring a CGT liability as a way of avoiding other, higher-rate taxes.[50] The term arbitrage is appropriate for describing this type of activity as these taxpayers may be attempting to re-characterise the legal form of their receipt without changing its economic substance. It is now recognised that a CGT rate cut that increases realisations through an increased arbitrary conversion of income to capital may have the effect of reducing efficiency due to a lowering of tax revenue overall as well as increases in other taxes that are distortionary.[51] This can undermine the integrity of the tax system 'by creating opportunities for artificial transactions to reduce income tax'.[52]

In conclusion, this section has summarised some of the concerns about the 50 per cent CGT discount. In our view there is a compelling case for reform of this feature of the Australian tax system. The following section considers one broad reform option available, involving complete removal or abolition of the 50 per cent CGT discount and some of the possible difficulties associated with this option.

3. COMPLETE REMOVAL

The case for the taxation of capital gains at full marginal tax rates has been well argued in the literature.[53] Notwithstanding the tax policy shortcomings of the CGT discount, there are some arguments against its complete removal from the Australian tax system. These relate to complexity, and impediments to such a reform owing to what can broadly be characterised as the politics of tax reform. These two factors are addressed below.

3.1 Complexity

If the CGT discount was removed and replaced with an alternative way of taxing capital gains this may result in increased complexity, compliance costs and administrative costs. The enactment of new CGT provisions in Australia has typically involved grandfathering of old law.[54] If a replacement policy is introduced that is accompanied

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[50] Alan J Auerbach, 'Capital Gains Taxation in the United States: Realisations, Revenue, and Rhetoric' (1988) 2 *Brookings Papers on Economic Activity* 595.
[51] Burman, above n 8.
[52] Daley, Wood and Parsonage, above n 1, 7.
[53] See 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.
[54] For example, on the enactment of Australia's original CGT provisions with effect from 1985, a decision was made to distinguish between pre-CGT and post-CGT assets. The grandfathered status of pre-CGT assets meant that any capital gain or loss involving such an asset is disregarded. In 1999-2000, the enactment of the CGT discount was accompanied by the retention of the indexation method, albeit with the indexation of cost base 'frozen' at the September 1999 quarter. In each of these instances, the better alternative from a tax policy perspective would have been to enact the new law without grandfathering old law.

by transitional rules or grandfathering of the previous law, compliance costs will typically be higher than in the absence of such rules.[55]

Miller refers to three main types of inherent tax system complexity: technical complexity, compliance complexity and structural complexity.[56] Excessive complexity increases filing and administrative costs and it has an impact on voluntary compliance,[57] although several studies have failed to document such a relationship.[58] In an empirical study in Australia – albeit in the context of personal income tax per se – the level of complexity was found to be directly related to taxpayer compliance costs and thence to taxpayers' commitment to compliance.[59]

Compliance costs[60] include three major components: monetary costs, time costs, and psychological costs to taxpayers. The private costs to a taxpayer of complying with the tax law can encompass indirect costs, in addition to direct costs, such as collecting documentation; accounting for tax; the fees paid to professional tax advisers; and remitting tax on products.[61] Indirect costs include the value of labour time associated with the completion of tax returns; the investment costs associated with acquiring intellectual capital necessary to enable this work to be done, and psychological costs that many taxpayers experience when trying to comply with tax legislation and regulation.[62]

According to Sandford, the more complex the tax legislation and regulation, the greater the knowledge gap – or information asymmetry – between legislators and taxpayers, and the greater the costs to the taxpayer of complying with the legislation.[63] However the costs of complying with taxation legislation are not limited to taxpayers. Where the tax authorities have a legal duty to monitor and enforce the legislation, the tax authorities themselves face costs of discharging their duties in accordance with the legislation. In a very real sense, these too can be regarded as compliance costs, not the

[55] Binh Tran-Nam and John Glover, 'Estimating the Transitional Compliance Costs of the GST in Australia: A Case Study Approach' (2002) 17(4) *Australian Tax Forum* 499.
[56] John A Miller, 'Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation' (1993) 68(1) *Washington Law Review* 1.
[57] Julie H Collins, Valerie C Milliron, and Daniel R Toy, 'Determinants of Tax Compliance: A Contingency Approach' (1992) 14(2) *Journal of the American Taxation Association* 1; Joachim Vogel, 'Taxation and Public Opinion in Sweden: An Interpretation of Recent Survey Data' (1974) 27(4) *National Tax Journal* 499.
[58] Thomas M Porcano, 'Correlates of Tax Evasion' (1988) 9(1) *Journal of Economic Psychology* 47; Yankelovich, Skelly and White, Inc, *Taxpayer Attitudes Study: Final Report*, Public Opinion Survey Prepared for the Public Affairs Division, Internal Revenue Service (New York, 1984).
[59] Margaret McKerchar, *The Impact of Complexity Upon Tax Compliance: A Study of Australian Personal Taxpayers* (Australian Tax Research Foundation, 2003).
[60] Jeff Pope, 'Estimating and Alleviating the Goods and Services Tax Compliance Cost Burden Upon Small Business' (2001) 11(1) *Revenue Law Journal* 2.
[61] Cedric Sandford, *Hidden Costs of Taxation* (Institute for Fiscal Studies, 1973).
[62] Ibid; Pierre Cléroux, 'Small Business and the Cost of Paperwork: The Goods and Services Tax' (1992) 9(4) *Journal of Small Business and Entrepreneurship* 27; Chris Evans, 'Studying the Studies: An Overview of Recent Research into Taxation Operating Costs' (2003) 1(1) *eJournal of Tax Research* 64; Maja Klun, 'Compliance Costs for Personal Income Tax in a Transition Country: The Case of Slovenia' (2004) 25(1) *Fiscal Studies* 93; Jarlath O'Keefe and Peter O'Hare, 'Increased Compliance Costs: VAT and Place of Supply of Services' (2008) (43, Indirect Taxes) *International Tax Review* 27; Luca Barbone, Richard Bird and Jaime Vázquez-Caro, *The Costs of VAT: A Review of the Literature*, Centre for Social and Economic Research (CASE) Network Report No 106/2012 (Warsaw, 2012).
[63] Cedric Sandford (ed), *Taxation Compliance Costs: Measurement and Policy* (Fiscal Publications, 1995).

'private' compliance costs of the taxpayer, but the publicly funded compliance costs for the tax regulator.

Some of the complexity associated with the complete removal of the CGT discount would relate to the likelihood of grandfathering rules to accompany the tax law change. If such grandfathering rules were enacted, there would be different tax law applying to different classes of CGT assets which would contribute to inefficiency and increased complexity in the tax system. There are also equity issues when grandfathered tax laws operate concurrently with their replacement provisions.

It appears that changes to the tax system add to complexity for tax advisers.[64] This can be due to having to learn new rules, as well as consider how they potentially apply to an array of clients. In a study of small business advisors in the US, Australia and New Zealand, a similarity between these jurisdictions was the high ranking of 'frequency of tax law changes' as a factor increasing complexity for advisers.[65]

The probability of increased compliance costs following a complete removal and replacement of the CGT discount is worthy of consideration. One of the main concerns in relation to removing the CGT discount would be the likely retention of grandfathered discount capital gains in the tax system.

3.2 Politics of tax reform

Although policy-makers did not describe the 50 per cent CGT discount as a permanent tax policy change, tax rate preferences, once granted, are difficult for governments to repeal. Since the 50 per cent CGT discount has been in place for longer than the original method of taxing capital gains, the discount has, arguably, become the 'status quo' in tax policy. Australia's recent history has demonstrated that implementing extensive, and meaningful, tax reform can be extremely problematic.[66] Such difficulties are especially apparent in the case of proposals to reduce or eliminate an existing tax expenditure. It is argued that the complete removal of the CGT discount would be politically difficult, particularly given that many taxpayers have vested interests in maintaining the status quo. It is for this reason that incremental changes, that still result in an improvement to existing tax policy, are more likely to be successful. This can be considered part of the politics of tax reform. On this point, Eccleston observed that:

> By its nature taxation requires governments to weigh up economic, ethical and political considerations when determining how to distribute the tax burden across society. Even when these difficult distributional questions have been

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[64] Brett Freudenberg et al, 'A Comparative Analysis of Tax Advisers' Perception of Small Business Tax Law Complexity: United States, Australia and New Zealand' (2012) 27(4) *Australian Tax Forum* 677, 709.
[65] Ibid 708. The respective rankings of this factor were 4th in the US, 2nd in Australia, and 3rd in New Zealand. The top four factors (in descending order) for each jurisdiction were: US: Partnerships, Estate & Gift Valuation, Tax Deferred Exchanges, and Frequency of Tax Law Changes; Australia: Non-resident trusts, Frequency of Tax Law Changes, Retirement Planning, and Small Business CGT Concessions; New Zealand: Overseas share investments and fair dividend rate method, Associated persons rule – income tax, Frequency of Tax Law Changes, and Land regime.
[66] For example, most of the tax reforms put forward in the Henry Review have not been adopted by successive governments.

> answered, policy makers have to confront a range of technical questions concerning compliance and administration.[67]

Tax reform can be difficult, as it involves motivating stakeholders to move from 'self-interest' to 'public interest',[68] which has led some to observe that tax policy reform can be the most difficult exercise in a democratic context.[69] This can be particularly difficult with an institutionally weak state that can be adversely influenced by short-term political pressure.[70] This has been illustrated at various points in time in Australian history, when tax policy has been 'reactive and opportunistic',[71] to maximise electoral benefit. Eccleston noted that:

> In theoretical terms, this preoccupation with short-term political imperatives is typical of what political scientists describe as a pressure pluralist policy environment in which the combination of an institutionally vulnerable state and the absence of a societal consensus for policy change undermines the prospects of comprehensive reform.[72]

Even when there is a popular government, tax reform can be problematic in the absence of broad community support.[73] Particularly in Australia there consistently appears to be partisan opposition to tax reform proposals, which has the tendency to polarise public opinion[74] and cause key business and community groups to be reluctant to have too close a relationship with either side of politics.[75]

Tran-Nam, Vu and Andrew identified that an incremental approach was the most viable option for personal tax reform in Australia[76] and this, arguably, applies to reform of the CGT discount. Incremental tax reform may be frustrating where it is characterised by compromises or the enactment of 'second-best policy', but it may be preferable to a drawn-out political process that leads to long delays or the complete abandonment of proposed policies. Although the complete removal of the CGT discount is a worthwhile reform in the longer term, there is a more immediate policy imperative to reduce the rate of the CGT discount.

However, if the CGT discount is to be removed and replaced, then it is critical that the proposed alternatives are critically evaluated, otherwise it is possible that concerns will not be adequately addressed or that there could be unintended consequences.

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[67] Richard Eccleston, *The Thirty Year Problem: The Politics of Australian Tax Reform*, Research Study No 42 (Australian Tax Research Foundation, 2004) 6.
[68] Ibid 7.
[69] Claudio M Radaelli, *The Politics of Corporate Taxation in the European Union* (Routledge, 1997).
[70] Michael M Atkinson and William D Coleman, 'Strong States and Weak States: Sectoral Policy Networks in Advanced Capitalist Economies' (1989) 19(1) *British Journal of Political Science* 47.
[71] Eccleston, above n 67, 68, referring to tax reforms introduced in Australia during the Fraser government years of 1975 to 1983.
[72] Ibid 68, citing Atkinson and Coleman, above n 70.
[73] Ibid 70, referring to the events in 1984 and 1985 in Australia.
[74] Ibid 141.
[75] Ibid 19-20.
[76] Binh Tran-Nam, Linh Vu and Brian Andrew, 'Personal Income Tax Reform in Australia: A Specific Proposal' (2007) 37(2) *Economic Analysis and Policy* 163.

4. ALTERNATIVES TO THE 50 PER CENT CGT DISCOUNT

As discussed in the previous section, an alternative to the CGT discount is the taxation of capital gains at full marginal rates. Taxation of capital gains at full marginal rates may or may not include the indexation of the cost base of CGT assets. Other alternatives include a separate rate schedule for capital gains, taper relief, and an annual exempt amount, as well as repeal of CGT altogether.[77] This section of the article considers the potential advantages and disadvantages of these policy alternatives.

4.1 Taxation of capital gains at marginal tax rates

Prior to the enactment of the 50 per cent CGT discount in the 1999-2000 fiscal year, net capital gains were taxed at the individual taxpayer's full marginal rates. Given the previous experience Australia has had with this approach, this is a viable alternative to the 50 per cent CGT discount. Notwithstanding that Australia's approach to taxing capital gains has, to date, been on a realisations basis, the accruals basis has been referred to in the literature as a possible alternative and it is also considered in this section of the article.

4.1.1 Taxing capital gains on accrual

In theory, capital gains could be taxed on an accruals basis, with taxpayers assessed annually on their accrued net capital gains. Taxation of capital gains on an accruals basis could also allow capital losses to be offset against other forms of assessable income.[78] Notwithstanding that taxing capital gains on accrual would eliminate the lock-in effect, there is no expectation of Australian policy-makers making such a change.[79]

The taxation of capital gains as they accrue is consistent with a pure comprehensive income tax system. However, the impracticalities of taxation on an accrual basis – including liquidity and valuation issues – have prevented the adoption of an accrual-based CGT in Australia and most other comparable jurisdictions.[80]

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[77] Another option, not referred to in this article, is a lifetime capped exemption for capital gains. A lifetime exemption for all asset types was a feature of the Canadian tax system from 1985. The form of the Canadian lifetime exemption, and the types of assets to which it applied, underwent various changes in the years following its enactment. From 1996, the lifetime exemption applying to capital assets generally was repealed and it was replaced with a lifetime exemption that only applies to certain types of assets. An advantage of a lifetime exemption is that it levels the playing field for all types of assets and it addresses the current bias in the tax system in favour of owner-occupied housing. The current bias for owner-occupied housing could be addressed by the lifetime capital gains exemption replacing the main residence exemption, perhaps with a rollover provision where the disposed asset was main residence housing. One of the main disadvantages is its complexity, given that it requires taxpayers and tax administrations to track capital gains over several tax years.

[78] Instead of the current treatment where they can only be offset against capital gains. The realisations basis requires such quarantining rules because, in their absence, taxpayers would have an incentive to realise capital losses and hold assets with accrued gains.

[79] Although the CGT events in the *Income Tax Assessment Act 1997* in aggregate result in most capital gains being taxed on a realisation basis, there are some CGT events that can occur in the absence of a disposal event. It is arguable that for such events, CGT is on a basis other than realisation.

[80] In Australia, the Asprey Report noted that 'the impracticability of taxing capital gains as they accrue is universally recognised: the tax can only attempt to deal with realised gains': Asprey Review, above n 25, 570. Despite the reluctance of tax jurisdictions to tax capital gains as they accrue, there are examples of accruals taxation of capital gains. For example, New Zealand taxes financial arrangements on an accruals basis and it uses the comparative value method (an accruals basis) for the taxation of foreign investment funds.

Cunningham argued that 'no one believes that a normative income tax based upon the Haig-Simons definition could ever be fully implemented; its importance is as an ideal'.[81] The fact that most tax jurisdictions do not tax all capital gains as they accrue is consistent with this view. As well as having potential issues related to liquidity and valuation, an accruals basis CGT could be costlier to administer than the current taxation of capital gains on a realisation basis.[82]

The concerns about valuation difficulties do not apply to all types of capital gains assets, given that assets such as shares in public companies are relatively easy to value. Given that this type of asset is also relatively liquid, there is an argument for introducing an accruals basis for taxing capital gains on shares. One of the benefits would be that taxpayers would no longer have large amounts of carry-forward capital losses from shares in the event of a downturn in share market performance.

Schenk noted that liquidity problems alone do not explain the realisation-basis system of CGT.[83] The liquidity argument is essentially one based on cash flow being such a serious concern that monetisation should be required for an imposition of tax. Schenk highlighted the inadequacy of this argument and noted that monetisation is an insufficient trigger for taxation since there would be no CGT if there were an exemption for a swap of properties.[84] Schenk noted that for most assets the need to provide cash to pay an annual tax on the change in value is akin to any other cost of owning an asset and is one that should be borne by the taxpayer.[85] This argument is relevant to the Australian context given that there are CGT events that do not require disposal of an asset for there to be a capital gain and, in turn, the imposition of tax.

4.1.2 Realisation

There is a compelling case for restoring taxation of capital gains at full marginal rates in Australia and this can be considered the tax policy ideal. One of the main weaknesses of taxing capital gains at lower rates than other forms of income is the incentive this creates for taxpayers to characterise ordinary income as capital gains. There are efficiency costs associated with taxpayers seeking to convert ordinary income into capital gains, including the fact that governments may be required to increase the rate of other distortionary taxes to recoup some of the revenue lost to this activity.[86] CGT is largely a tax system integrity measure that protects the income tax base, because in its absence there would be an incentive to convert ordinary income into capital gains.

A tax system with a preferential CGT rate compromises vertical equity, since the heavily skewed distribution of capital gains means that high income taxpayers receive most of the benefit of the preference. Horizontal equity requires consistent treatment of taxpayers with the same income. As outlined earlier, a tax system where the proportion of taxable income that is capital gains influences a taxpayer's average tax rate is one that does not satisfy the policy criterion of horizontal equity. The integrity and fairness

[81] Noël Cunningham, 'Taxation of Capital Income and the Choice of Tax Base' (1996) 52(1) *Tax Law Review* 17.
[82] George Fane and Martin Richardson, 'Negative Gearing and the Taxation of Capital Gains in Australia' (2005) 81(254) *Economic Record* 249.
[83] Deborah Schenk, 'A Positive Account of the Realization Rule' (2004) 57(3) *Tax Law Review* 355.
[84] Ibid.
[85] Ibid.
[86] Auerbach, above n 50, 599.

of the tax system can be improved by aligning the tax rate on capital gains with that on other forms of income.

4.2 Indexation of capital gains

Prior to the enactment of the 50 per cent CGT discount in 1999, a feature of Australia's then regime for taxation of capital gains at full marginal rates was the indexation of the cost base of CGT assets. If the CGT discount was to be abolished and capital gains taxed at full marginal rates once again, a further consideration for policy-makers would be whether to allow the indexation of cost base. Indexation of the cost base ensures that the taxation of net capital gains applies to real rather than inflationary gains.

While there is merit in the argument that inflationary gains should not be subject to taxation, it is difficult to justify inflation adjustments to the cost base of capital gains assets and not to other parts of the tax system. Where inflation adjustments apply to capital gains and not to other parts of the tax system, there are compromises to equity and efficiency, as well as arbitrage opportunities arising from the fact that the various parts of the tax base are subject to different inflation rules. According to Burman, the non-indexation of cost base, and the resultant taxation of inflationary capital gains, is smaller than the 'inflation tax' on other forms of capital income.[87] This is because of the greater benefit that arises from taxpayers being able to defer the tax on capital gains.[88]

Indexation need not be part of a regime that taxes capital gains at full marginal rates, given its effect on complexity and the current environment of low inflation. Nevertheless, policy-makers in Australia might view indexation as a necessary feature of CGT regime that taxes capital gains at full marginal rates, especially if there was a return to a high inflationary environment.[89]

4.3 Separate rate schedule for capital gains

Another alternative to the CGT discount is a separate rate schedule for capital gains, similar to that which operates in the US. From a tax policy design perspective, and in accordance with equity principles, the separate schedule should include several different CGT rates, rather than one flat tax rate for capital gains. Introducing a separate rate schedule would be one way of changing the real tax rates on capital gains.

Taxing capital gains under a separate schedule would represent a significant departure from the current approach and one which would be accompanied by increased complexity. Furthermore, such a change would be difficult to justify according to tax design principles. It is questionable whether there is a tax system design principle that requires capital gains to be taxed under a separate schedule at lower rates than other income.

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[87] Burman, above n 8, 147.
[88] Ibid 147.
[89] It is also of note that the Henry Review recommended a 40 per cent savings income discount for individual taxpayers, to apply to their net interest income, net residential rental income (including related interest expenses), capital gains and losses, and interest expenses related to listed shares: Henry Review, above n 39, Recommendation 14. This recommendation would address the inconsistency that would occur by indexing the cost base of capital gains assets, while not providing an inflation adjustment to other forms of capital income. The recommendation for the discount to apply to losses as well as gains would reduce arbitrage opportunities that currently exist.

4.4 Taper relief

Taxing capital gains using a taper relief system involves a lowering of the CGT rate – or the amount of capital gain to be included in assessable income – according to the length of time that an asset is held prior to disposal.[90] CGT taper relief operated in the United Kingdom for personal income taxpayers from 1998 until 2008.

The introduction of a taper relief system could allow policy-makers to increase the minimum holding period for the asset that is subject to the CGT event before the taxpayer can qualify for the CGT rate preference.[91] An increase in the minimum holding period could address concerns about the generosity of the 50 per cent CGT discount after a holding period of more than 12 months.[92] It may be that in the current regime there is an incentive for some taxpayers to time the realisation of capital gains to be as close as possible to when they qualify for the CGT discount. Notwithstanding the benefits of deferral, such timing may ensure the taxpayer receives the maximum benefit of the CGT discount.[93]

Taper relief appears to be the least preferred option for reforming the taxation of capital gains for personal taxpayers in Australia, and it would certainly introduce more complexity into the tax system.

4.5 Annual exempt amount

An alternative to the current system of taxing capital gains in Australia is to allow all taxpayers a non-cumulative annual exempt amount (AEA) for net capital gains in each year of income. The UK and South Africa are examples of tax jurisdictions that have used an AEA.[94]

Evans, Minas and Lim set out the case for the introduction of an AEA, explaining that part of its appeal is that a large proportion of personal taxpayers with small capital gains could be removed from the 'CGT net'.[95] The design of an AEA should allow taxpayers to claim the annual exempt amount without having to calculate their net capital gain in every case. Otherwise taxpayers would still need to ensure that they keep records of their CGT asset expenditure and proceeds to calculate their net capital gain for the year to ascertain that they are within the AEA.

The AEA proposed by Evans, Minas and Lim addressed this consideration by ensuring that taxpayers would qualify for the AEA where total capital proceeds from all relevant CGT events for the taxpayer are equal to or less than twice the AEA threshold.[96] This criterion would promote simplicity, as it only requires the taxpayer to consider their

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90 Minas, above n 37.
91 Ibid.
92 Ibid.
93 Ibid.
94 Canada is another country that operated an approximation of an annual exemption on capital gains, albeit on a narrower range of assets. Specifically, between 1977 and 1984, the Canadian tax system included an annual deduction for up to CAD 1,000 of taxable capital gains on 'Canadian securities'. The measure was repealed when Canada introduced the Lifetime Capital Gains Exemption. See Stephen Richardson and Kathryn Moore, 'Canadian Experience with the Taxation of Capital Gains' (1995) 21(Supp) *Canadian Public Policy/Analyse de Politiques* S77, S88.
95 Chris Evans, John Minas and Youngdeok Lim, 'Taxing Personal Capital Gains in Australia: An Alternative Way Forward' (2015) 30(4) *Australian Tax Forum* 735.
96 Ibid.

capital proceeds for the year, rather than calculate their net capital gain. Under the other AEA criterion, taxpayers choose to calculate their entitlement to the AEA when their net capital gain for the year was equal to or less than the AEA threshold.

There may be some instances, though, where the taxpayer would choose to maintain records, where they anticipated that the threshold may be exceeded. A compelling argument in favour of the AEA proposal by Evans, Minas and Lim is its main simplicity benefit – the removal of up to 71 per cent of existing Australian personal taxpayers currently exposed to the compliance burden of the CGT regime from their obligations without loss of revenue to the government.[97]

The AEA proposed by Evans, Minas and Lim would still operate as a CGT-free threshold for those taxpayers with a net capital gain in excess of the threshold. That is, its purpose is not only to exempt from CGT taxpayers who meet one of the above criteria, but it would also allow taxpayers with net capital gains above the threshold to apply the AEA to reduce their taxable net capital gain by the amount of the AEA.[98] Like the tax-free threshold for income tax in Australia, the AEA proposed by Evans, Minas and Lim is non-cumulative — to the extent that a personal taxpayer is unable to use part or all of the AEA in a given tax year, it would not be available to be carried forward or backward to other tax years.

An AEA could improve vertical and horizontal equity by imposing a per-taxpayer limit on the amount of net capital gains that are eligible for the preference. Although the AEA gives effect to a zero tax rate for net capital gains up to the amount of the threshold, all net capital gains over the threshold amount would be subject to tax at the taxpayer's marginal tax rate. The important distinction between the 50 per cent CGT discount and the AEA is that the AEA imposes a per-taxpayer limit on the amount of the preference, whereas the CGT discount provides a tax preference of a very large magnitude in aggregate.[99]

The AEA could also restore equity to the CGT system, as the preference for capital gains it gives effect to is progressive in its impact. In terms of the percentage by which the AEA reduces the taxpayer's real tax rate on capital gains, it is directed more towards lower-income taxpayers with capital gains, rather than being heavily skewed towards higher-income taxpayers, as is the case with the CGT discount.

While there are some benefits to the proposed AEA, it is arguable that there are some aspects of it that could potentially lead to problems post-implementation. For example, once an AEA is introduced there may be pressure to increase the threshold amount. Another concern is that the AEA could influence taxpayers to time their capital gains realisations in such a way that they 'max out' the exempt amount in each year, to the extent that this is possible.

Notably, in addition to the AEA in the UK, that jurisdiction also has a separate schedule of lower rates applying to capital gains, and these rates were recently reduced.[100] This is an example of the fact that despite the AEA being a type of tax preference, there can

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[97] Ibid.
[98] Ibid.
[99] This impedes revenue forecasting as there is an absence of data on the accrued capital gains of taxpayers.
[100] As of April 2016, the rates for CGT in the United Kingdom are: basic rate taxpayers 10 per cent (down from 18 per cent) and higher rate taxpayers 20 per cent (down from 28 per cent).

be still pressure from taxpayers to provide additional concessional tax treatment for capital gains.[101] If the same were to eventuate in Australia it would arguably constitute a 'worst-case scenario'. While the AEA may be a viable alternative to the CGT discount, the risk of the UK experience being repeated in Australia should be considered.

4.6 Repeal capital gains tax

Some commentators have argued that the total repeal of CGT in Australia is an alternative to the current system of taxing capital gains.[102] While some have argued for the repeal of CGT,[103] to achieve tax neutrality between taxing consumption today or tomorrow,[104] we do not support a tax system that does not tax capital gains. Such a tax regime would be problematic from the perspective of vertical equity, horizontal equity and efficiency.[105] The inefficiency problems arise from tax planning that is aimed at characterising what would otherwise be income receipts as tax-free capital gains.[106]

In conclusion, for the reasons that have been outlined in this section of the article, we suggest that incremental reform is a way that may address the concerns with the 50 per cent CGT discount in the short term.[107] The following section considers incremental reform in more detail.

5. Incremental reform

Tran-Nam, Vu and Andrew argued that an incremental approach is the most viable option for personal tax reform in Australia.[108] There is also a view in the literature that incremental changes that are too frequent may detract from the perceived stability of the tax system.[109] A possible incremental change to address concerns about the CGT discount is to reduce the CGT discount rate and implement an annual cap of the amount of CGT discount that a taxpayer can claim each year.

5.1 Reducing the CGT discount rate

Section 2 of this article outlined some of the concerns with taxing capital gains at preferential rates; in aggregate these concerns highlight the case for taxing capital gains at full marginal rates. Notwithstanding the arguments set out in the tax literature for capital gains to be taxed at full marginal rates, there may be some political considerations that restrain tax reform generally. Incremental reform in relation to the

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[101] It is also notable that the UK AEA is higher in magnitude than the one proposed by Evans, Minas and Lim, above n 95.
[102] Such arguments are not limited to Australia. See, eg, Barry Bracewell-Milnes, 'Capital Gains Tax: Reform Through Abolition' in Barry Bracewell-Milnes (ed), *A Discredited Tax: The Capital Gains Tax Problem and Its Solution* (Institute of Economic Affairs, 1992) 1.
[103] Daley, Wood and Parsonage, above n 1, 12, citing Robert Carling, 'Right or Rort? Dissecting Australia's Tax Concessions' (Centre for Independent Studies Research Report, 2015).
[104] Alternative arguments are that the 'risk free' part of returns should not be assessed: James Mirrlees et al, *Tax by Design: The Mirrlees Review Vol 2* (Oxford University Press for Institute for Fiscal Studies, 2011) 284.
[105] The New Zealand experience of not having a comprehensive CGT has, arguably, highlighted such problems.
[106] This is also of concern in a tax system that taxes capital gains at preferential rates.
[107] The longer-term policy goal is one of taxing capital gains at the same rate as ordinary income.
[108] Tran-Nam, Vu and Andrew, above n 76.
[109] Binh Tran-Nam et al, 'Personal Income Tax Reform in Australia: The Way Forward' (2006) 21 *Australian Tax Forum* 441.

CGT discount would increase the real CGT rate so that more than 50 per cent of capital gains are taxable at all levels of income. It is possible to achieve reform of CGT that improves horizontal and vertical equity and increases tax revenue — albeit to a lesser degree than CGT at full marginal rates — by reducing the rate of the 50 per cent CGT discount.

Reducing the CGT discount may be characterised as a necessary compromise to achieve an improved policy outcome. Such a reform may have more political acceptability, although it may still involve difficulties, as the experience in Australia shows. In 2010, the then Rudd Labor Government swiftly ruled out the Henry Review recommendation to reduce the CGT discount to 40 per cent; although more recently, the Labor Opposition led by Bill Shorten proposed a 25 per cent CGT discount as one of its policies during the 2016 federal election campaign.[110] The current Coalition government appears not to support any plans to reduce the current the 50 per cent CGT discount. The difference in CGT policy between Australia's two major political parties illustrates the 'adversarial' nature of tax reform debate referred to by Eccleston.[111] Given the apparent political difficulties associated with implementing a minor change in the rate of the CGT discount, the prospects for complete removal of the CGT appear quite limited. Nevertheless, incremental reform that improves on the current policy should be pursued.

It is apparent that the 50 per cent CGT discount does not perform well against the traditional tax policy criteria of horizontal and vertical inequity; and it causes inefficiency due to the rate difference between ordinary income and capital gains. If the reduction of the 50 per cent CGT discount is considered the most politically feasible option for reform of CGT, it is worthy of consideration. Although there are inherent problems with a rate differential between capital gains and ordinary income, a higher rate of CGT would improve vertical and horizontal equity and increase CGT revenue.

Rynne indicated his support for incremental reform, noting that it would reduce the demand for property investment.[112] Such reform is also supported by Daley, Wood and Parsonage who argued for a 25 per cent discount for individuals and trusts to be introduced.[113] They suggested that such a reduction to the CGT discount rate could be phased in over a five-year period with the discount reduced by 5 percentage points each year. This should avoid 'shocks' to the market and a scenario of investors rushing to sell properties.[114] Such an incremental reduction to the CGT discount rate would be a better alternative than grandfathering previous CGT rates.

It is acknowledged that such a reduction exceeds the Henry Review's recommendation of a reduction in the discount to 40 per cent. However, it has been argued that the Review, in coming to this conclusion, failed to take into account the 'additional and sizeable tax advantages for capital gains'.[115] According to projections by the Grattan

[110] Lenore Taylor, 'Labor promises to cut negative gearing and capital gains tax concessions', *The Guardian* (13 February 2016), https://www.theguardian.com/australia-news/2016/feb/13/labor-promises-to-cut-negative-gearing-and-capital-gains-tax-concessions (accessed 24 December 2018).
[111] Eccleston, above n 67.
[112] Brendan Rynne, 'Housing "bubble" to deflate slowly in Sydney and Melbourne as house values gently roll back', KPMG NewsRoom (21 July 2017), http://newsroom.kpmg.com.au/housing-bubble-deflate-slowly-sydney-melbourne-house-values-gently-roll-back/ (accessed 24 December 2018).
[113] Daley, Wood and Parsonage, above n 1, 3.
[114] Ibid 46.
[115] Ibid 36.

Institute, once fully implemented, a 25 per cent CGT discount would raise additional tax revenue of AUD 3.7 billion per year.[116]

There appears to broad support for reducing the rate of the CGT discount, as indicated in several of the submissions to the Australian Government's 2015 Re:think Discussion Paper.[117]

5.2 Annual limit to the amount of CGT discount claimed

Currently, one of the issues with the CGT discount is that there is no upper limit of the amount of the 50 per cent CGT discount that can be claimed.[118] Given that a large percentage of capital gains are realised by those on higher taxable incomes, introducing a limit on the amount of the CGT discount claimed each year for each individual taxpayer is a way to reduce the vertical inequity aspects of the policy in its current form. To the extent that the CGT discount shelters capital gains from full marginal rates of tax, the progressiveness of the personal income tax system is undermined. An annual CGT discount limit of AUD 50,000, accompanied by a reduced rate of CGT discount, would improve vertical equity in the tax system.[119]

Any arguments about a lack of 'political' viability of such a reform should consider that a very small proportion of taxpayers realise capital gains that exceed the proposed cap. Furthermore, the benefits of deferral and the continuation of the CGT discount, albeit at a reduced rate, would ensure that there is still a significant preference for capital gains compared to other forms of assessable income.

6. CONCLUSION

This article has considered two broad alternatives for the reform of the 50 per cent CGT discount. The first of these is the complete removal of the CGT discount and its replacement with an alternative means of taxing capital gains such as the annual exempt amount proposed by Evans, Minas and Lim. The second is retaining the CGT discount with amendments that would have the effect of better aligning it to the traditional 'good' tax system policy criteria of vertical and horizontal equity, efficiency and simplicity. This may be achieved by way of a CGT discount at a reduced rate accompanied by an annual limit on the amount of the discount that a taxpayer can claim in a fiscal year.

Incremental reform would address many of the concerns raised with the CGT discount and such reform appears to have the support of a significant proportion of the taxpayer population. While we are of the view that the CGT discount should not persist in its current form, incremental change provides the prospect of more immediate reform. A reduction in the rate of the CGT discount together with introduction of an annual CGT

[116] Ibid 37: This is slightly different to prior Treasury estimates as their estimate is based on a subsequently released 2013-14 sample file.
[117] For example, the KPMG submission recommended a reduction of the CGT discount to 25 per cent and that the discount apply to interest income and unfranked dividend income, as well as capital gains: David Linke and Grant Wardell-Johnson, *Tax Reform: KPMG's Submission to Treasury* (July 2015) 35, https://assets.kpmg.com/content/dam/kpmg/pdf/2015/07/tax-reform-kpmg-submission-to-treasury-july-2015.pdf.
[118] For example, a taxpayer with a discount net capital gain of AUD 5 million paying tax at a marginal rate of 46.5 per cent would be receiving a tax rate preference of approximately AUD 2.325 million.
[119] Policy-makers could also consider a limit of AUD 100,000 for years in which a large capital gain accrued over a minimum period of time, such as 20 years.

discount limit amount would constitute an improvement to the tax system in terms of vertical and horizontal equity, and efficiency. We are of the view that such incremental changes should not be accompanied by grandfathering of the current law, as this would compromise the intended improvements to simplicity and efficiency. However, even with such incremental reforms, there is the need for continued long-term policy reform to ensure that capital gains are appropriately taxed in Australia.