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Reforming capital gains taxation in Australia

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David Ingles

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Overview

A capital gain is an increase in the value of an asset such as a property or shares. The gain can be measured either over a year (an accrual basis) or at the time of disposal (a realisation basis). The comprehensive income ideal implies that accruing real capital gains should be taxed as ordinary income but compared with this ideal capital gains are taxed very concessionally. This paper examines the question of whether Australia should continue to provide concessions amounting to well over $10 billion a year and concludes that it should not.

Short-term capital gains have always been taxed as income in Australia but gains on assets held for more than a year were first taxed in 1986 under the Hawke/Keating tax reforms. Pre-1986 assets were exempted and housing was not included. Gains on post-1986 assets were taxed in full but indexation applied. The Howard/Costello Government abolished indexation when, following the 1999 Ralph Review of Business Taxation, it substituted a 50 per cent concession, allowing half of any capital gain to be tax free; however income derived from capital continued to be taxed in full.

This situation is of particular benefit to the well-off for two reasons.

First, the well-off receive a disproportionate share of capital gains—the top one per cent of taxpayers receives 39 per cent while the top 10 per cent receives 64 per cent of such gains.

Second, the higher the marginal income tax rate that would otherwise apply, the higher the benefit that is afforded by the concession. A taxpayer on the top rate of 46.5 per cent benefits from a 23 percentage point discount but a taxpayer on the zero marginal rate (income under $14,000) gets no benefit at all.

These concessions undermine the progressivity of the income tax regime and make it possible to craft executive pay packages with a strong bias towards such tax breaks. There is also a raft of concessions for the self-employed such that they are unlikely ever to face a capital gains tax (CGT) bill.

In the US, capital gains concessions are similarly egregious. US billionaire Warren Buffet has complained that his $47 million income, mainly from capital gain, was taxed at only 17 per cent, much lower than his secretary's 30 per cent bill.

Why is this form of tax so concessional? The rationale behind the concessions is that they encourage risk-taking and an enterprise culture but actually a properly designed CGT is neutral with respect to risk. Nor does a concessional rate work to attract foreign investors because foreign holders of Australian shares are not taxed on their gains. And if it is considered desirable to tax income from capital at a lower rate than other income, why restrict it only to capital gains? The incentive argument does not hold water.

The paper concludes with a number of suggestions for reform, principally:

- eliminating the 50 per cent discount
- incorporating all pre-1986 assets
- deemed realisation of assets on death

- including owner-occupied housing above a certain value.

These changes would raise a great deal of revenue, thus allowing for meaningful tax reform, and contribute to a sounder and fairer tax system.

Introduction

Concessionality is a common feature of CGT regimes in all OECD countries (Treasury 2008a), reflecting the practical difficulties of measuring capital gains and the political difficulties of taxing the full incomes of the wealthy. Australia is no different with the taxation of capital gains being highly concessional when compared to the Schanz-Haig-Simons comprehensive income ideal of taxing in full accruing real gains at marginal income tax rates. Most capital gains are taxed at a lower rate than the normal income tax rate and only on a realisation basis.

In the comprehensive income tax tradition, capital gains should be taxed as part of ordinary income—CGT is not a tax on wealth. The argument is that 'a buck is a buck' whatever its source. If capital gains are not considered an integral part of the income tax base, all sorts of avoidance possibilities are opened up. This argument underlay the 1985 decision to include capital gains in the tax base in Australia. According to the Australian Treasury (Treasury):

The lack of a Capital Gains Tax represents a structural defect in the income tax system which lies at the core of many avoidance arrangements: if income can be converted into or dressed up as capital gains, income tax can be avoided completely (Treasury 1985, ch. 7).

The Treasury further argued:

As for investment, the introduction of a Capital Gains Tax could be seen as ameliorating some of the present distortions on decisions to invest. At the margin the absence of a CGT means that decisions to invest are determined not only by the overall yield of a project but also by the composition of that yield as between capital gains and income.

It is not apparent that assets offering returns as capital gains are in some way special so that discrimination against other forms of investment is warranted (Treasury 1985, ch. 7).

In Australia, the following applies to the taxation of capital gains:

- a company's gains are fully taxable
- only two-thirds of super fund gains are taxable, making the effective rate only 10 per cent (other super fund income is taxed at 15 per cent)
- only half of any long-term gains (over 12 months) made by individuals and trusts are taxable as income.

The value of this last concession is indicated by the Treasury's measure of the tax expenditure on capital gains discounts for individuals and trusts—$9.4 billion in 2008–09. This implies that over half of total assessable gains are concessionally taxed. The main residence (family home) is exempt.

Capital gains receipts are estimated to reach $15.7 billion in 2008–09, to fall in the following year to $14 billion and then to resume an upward trajectory, reaching $17 billion in 2011–12 (Treasury 2008c, p. 5.17). Downward revisions are now likely because of the economic crisis; capital gains are a particularly volatile item of revenue. After superannuation, the $9.4 billion capital gains tax concession is one of the large items in the Treasury's *tax expenditure* measure (Treasury 2009), estimated to total $67 billion in 2008–09.

The Treasury's *Tax Expenditures Statement* for 2008 includes a new item in Appendix C, the tax expenditure on the main residence exemption, which is calculated to reach $41.5 billion in 2008–09. Against this must be set about $12 billion of offsets for interest and other costs, making the net cost of exempting the family home something like $30 billion and the total capital gains concession, on Treasury figures, $39 billion. This is 30 per cent of the total income tax revenue of $130 billion, which, if politically feasible to collect, would be a significant amount of money to spend on tax reform. For example, it would finance a tax cut of about $4,000 per taxpayer.

Most OECD countries have capital gains taxes but they typically yield less than five per cent of the revenues from the income tax and always less than one per cent of GDP. Very few countries levy CGT on owner-occupied housing. Essentially, the CGT acts to 'backstop' the income tax system because without one it is possible to convert ordinary taxable income into non-taxable capital gains.

Evans identifies a number of key propositions for an ideal tax on capital gains. These include, so far as is practicable, that capital gains should be taxed no differently from other forms of income, and they should be taxed at prevailing income tax rates in order to minimise the possibilities for tax arbitrage that inevitably occur when capital gains are taxed differently from other income streams (Evans 2002, p. 5). The current regime falls far short of this ideal.

Quite apart from the CGT discount, there are elements of capital gain that escape tax. Pre-1986 assets are exempt. Further, CGT tax can be deferred indefinitely by owners bequeathing their assets upon death to beneficiaries who continue to hold them. The beneficiary only pays CGT if and when the asset is sold. Also, there are extensive small business concessions.

The main recommendations of this paper are as follows:

- abolish the capital gains discount so that capital gains of both individuals and trusts are taxed at full marginal rates
- re-introduce a form of averaging
- abolish the super fund CGT concession
- remove the exemption for pre-1986 assets by applying a cost base at a current valuation date
- remove most of the small business concessions
- disallow negative gearing
- apply CGT to owner-occupied housing above a threshold of, say, twice the median house price
- apply a deemed realisation of CGT assets upon death.

Current CGT concessions

Compared with the comprehensive income tax benchmark, a range of concessions apply.

The principal concession is the capital gains discount on assets held for at least 12 months whereby only half the gain is added to taxable income in the year. This costs $9.4 billion. A one-third discount applies to capital gains of super funds, reducing applicable tax from 15 to 10 per cent. This costs $.5 billion (Treasury 2009). These discounts are not available to corporations unless they are life offices or friendly societies carrying on a super fund business.

Foreign portfolio investors in Australia are not liable for Australian CGT but investors in 'real property' are.[1] If foreigners own shares in an Australian corporation, there will be a tax on capital gains realised by the corporation but not on the shares themselves.[2] Assets that are 'used in carrying on a business in Australia via a permanent establishment' are also taxable.

There is a concession, uncosted by Treasury, involved in taxing capital gains on realisation rather than annually as the asset appreciates (accrual taxation). As described later, this is a significant concession.

Under the comprehensive income tax benchmark, ideally *real accruals* (the annual price increase after allowing for inflation) rather than *nominal realisations* should be taxed. Inflation works to raise receipts artificially and the accrual effect to reduce them. On some assumptions these adjustments broadly cancel out.[3]

A further significant concession is the exemption of owner-occupied homes, which account for around 44 per cent of total assets held by Australians or about $2 trillion. The Treasury estimate of the gross cost of the main residence CGT exemption is $41 billion per annum,[4] but interest and other deductions amount to $18 billion. If two-thirds of the deductions relate to capital gains and about one-third to imputed rent (the ratio between these two types of income on the Treasury figures) this suggests a deduction of $12 billion from the gross figure, leaving a net $29 billion for the housing capital gains exemption.

In some circumstances rollovers are permitted, meaning that no CGT is triggered on the sale and subsequent purchase of a similar asset; however, the former cost base continues to apply. This includes assets transferred at death, as a result of a court-ordered divorce decree and when a company is acquired in return for shares of the acquiring company (scrip-for-scrip takeovers). Gifts of

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[1] On 7 December 2006, the Australian Parliament passed the Tax Laws Amendment (2006 Measures No. 4) Bill 2006. The Act amended the capital gains tax (CGT) provisions of the *Income Tax Assessment Act 1997* (Cth) as they relate to foreign residents.

The principal effect of the amendments was to narrow the range of assets held by foreign residents that are subject to the CGT provisions. These measures enhanced Australia's status as an attractive place for business and investment by addressing the deterrent effect for foreign investors of Australia's broad foreign-resident CGT tax base.

Under the new provisions, foreign residents are subject to the CGT provisions if they hold 'taxable Australian property' as defined by the Act and a CGT event occurs concerning that property.

Broadly, taxable Australian property includes: real property located in Australia; membership interests in resident or non-resident entities that directly or indirectly own real property in Australia (which comprises 50 per cent or more of their asset base, as calculated under a prescriptive test); and assets that are used in carrying on a business in Australia via a permanent establishment.

'Therefore, importantly, a foreign resident will not be subject to CGT when disposing of shares or units that it directly owns in an Australian public or private entity, provided that entity does not own real property in Australia which comprises 50 per cent or more of its asset base. This represents a major win for foreign resident investors who directly invest in Australian securities' (Mallesons Stephen Jaques 2006).

[2] Corporations tax payable in Australia by foreign corporate investors would normally generate corporations tax offsets in the home country under double tax relief treaties.

[3] The ABS (2007) estimated net private wealth in Australia in 2005–06 at $4.5 trillion or around five times GDP, an average of $655,000 per household or $563,000 net of debt. Treasury (2008a, p. 181) stated that owner-occupied dwellings comprised 44 per cent ($2 trillion), other property 16 per cent ($.7 trillion) and superannuation 13 per cent ($.6 trillion). Non-super and non-home assets are estimated at $2 trillion. I assume a three per cent real annual gain ($60 billion) based on the historical real return on equities of 7.5 per cent, of which the dividend stream has averaged four per cent. Property has historically performed almost as well as equities. If this $60 billion were taxed at 40 per cent on accrual, it would raise $24 billion compared with actual receipts of $15 billion. The net concession of $9 billion is comparable with the Treasury estimate of the CGT concession, also at $9 billion. The implication is that the departures in the Treasury estimate from the real accruals ideal may broadly cancel out.

[4] The housing figure is not included in the main tables of aggregate tax expenditures (Treasury 2009).

capital assets trigger a CGT liability to the donor in contrast to the situation on death where no tax is triggered but the cost base[5] of the original purchaser is passed on to the beneficiary of a bequest. A CGT liability only arises if the asset is sold.

There are also small business CGT concessions as follows:

- Fifteen year exemption—a capital gain on a business asset is exempt if the taxpayer has owned the asset continuously for at least 15 years and is at least 55 years old and retiring or is permanently incapacitated.
- Active asset reduction—the taxable value of capital gains on a business asset (active asset) is reduced by 50 per cent. This applies in addition to the general 50 per cent discount for assets owned at least 12 months, reducing the taxable component to 25 per cent of the gain. There is also rollover relief for active assets.
- Retirement exemption—a capital gain on a business asset is exempt up to a lifetime limit of $500,000 if the individual is 55 or over or if the money from the sale of the asset is paid into a complying super fund, ADF or retirement savings account by an individual aged under 55.
- Rollover exemption—tax is deferred if proceeds from disposal of a small business asset are reinvested in a new small business asset.
- A small business may apply as many concessions as it is entitled to until its capital gain is reduced to nil.

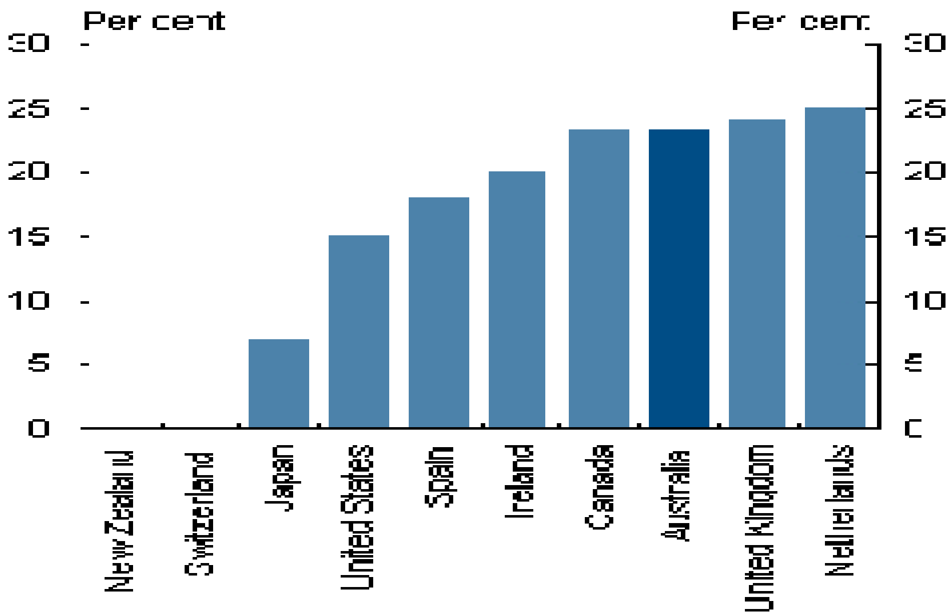
How small business is ever liable to pay CGT is therefore a mystery. The small business concessions were introduced under the Howard Government, which appeared to be obsessed with removing CGT from the small business sector. The small business concessions cost appears to be well under $.5 billion.[6]

Despite the concessions, the Warburton-Hendy report, *International comparison of Australia's taxes,* found that the top CGT rate on shares in Australia, at 24 per cent, was higher than the international average of around 17 per cent (2006, chart 6.3). This finding is confirmed more recently by Treasury as shown in Figure 1.

[5] Cost base means the original purchase price adjusted for capital improvements, dividend re-investment and the like.

[6] Calculated by subtracting the cost of the capital gains discounts from the gross CGT tax expenditure. This yields a cost of $210 million. This may be too low as Evans (2003) gives a similar cost from eight years earlier.

Figure 1: Comparative tax rates—capital gains on shares, OECD-10, 2007



Source: Treasury 2008a, Chart 5.9, p. 209.

Of course, the issue for Australia is whether we should strive to be consistent with international practice or instead optimise our own tax system. The fact that CGT does not apply to foreign portfolio investors significantly reduces the risk of choking off foreign investment, although it may apply to some property investors. If the CGT regime were tightened, it might be desirable to specifically exclude foreign investors in real property to maintain international tax competitiveness.

Incidence of the tax concessions

Capital gains accrue to the better-off sections of the population in a greater proportion than other income categories and to an astonishing extent, as shown in Treasury's *Architecture of Australia's tax and transfer system* (2008a). Net capital gain is distributed as follows:

Table 1: Distribution of net capital gain among taxpayers

2005–06	**Bottom**		**Top**		
	20%	50%	20%	10%	1%
Net capital gain share	4.2	13.3	73.7	64.2	38.6

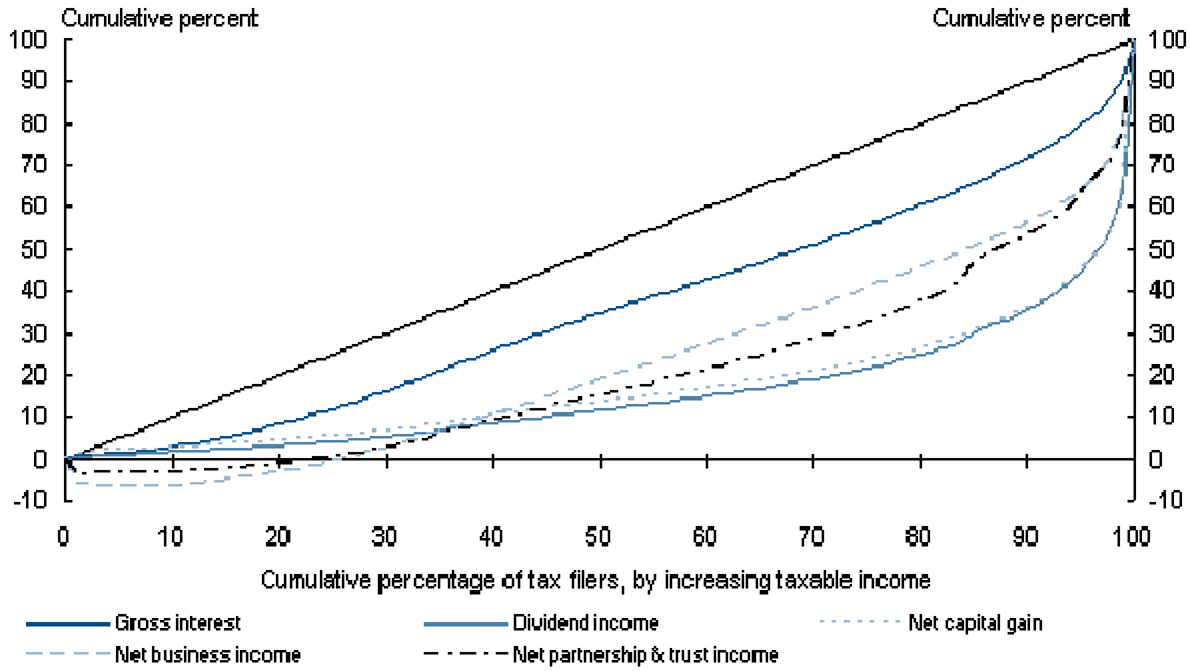
Source: Treasury (2008a), Table 3.1.

The table shows that the top 20 per cent of income earners receives 74 per cent of all taxable gains compared to a four per cent share among the bottom 20 per cent of earners. This reflects the highly unequal distribution of wealth generally (ABS 2007). The top one per cent of earners receives an astonishing 39 per cent of all taxable gains. Not only are capital gains distributed in an extremely unequal manner but the benefit of the 50 per cent concession becomes greater as the marginal tax rate otherwise applicable rises. Thus a person on the zero marginal rate gets no benefit; someone on

$50,000 per annum gets a 15 per cent benefit; and someone on $200,000 per annum gets a 23 per cent benefit.

Capital gains, along with dividend income, are the most unevenly distributed of all capital income items as is shown in Figure 2. This figure indicates rising inequality as the curves approach the right-hand origin. The straight line is the line of perfect equality.

Figure 2: Distribution of selected capital income items, 2005–06



Source: Treasury 2008a, chart 3.10.

Similar findings are reported by Burman (2009), who notes that the top nine per cent of income earners (incomes over $80,000) reported less than one-third of all income but realised two-thirds of all capital gains and paid more than three-quarters of all CGT in 2005–06. 'It is clear that taxing capital gains plays an important role in the overall progressivity of the income tax in Australia' (Burman 2009, p. 5).

Overseas experience confirms that CGT is highly progressive:

- In Canada, one per cent of returns accounted for 60 per cent of capital gains in 1997.
- In the US, the richest 0.4 per cent of returns accounted for nearly 60 per cent of such gains in 1998.
- In the UK, less than 0.1 per cent of returns accounted for 60 per cent of reported capital gains in 1997–98 and paid more than 75 per cent of all CGT.
- Capital gains are an important source of income for the wealthy but much less so for the middle class (Burman and White 2003, p. 365).

For the wealthy, turning income into capital gain has become a highly-favoured form of tax avoidance. A company executive can be substantially remunerated in the form of shares or stock options and, assuming the share price rises, is liable to pay tax on the eventual gain at half the income tax rate. For example, taxpayers on $180,000 per annum will normally pay $60,700 in income tax plus the Medicare levy. If they are able to take half this income as a capital gain, they will bring their taxable income down to $135,000 per annum and save $18,700 in tax. Obviously, the savings are much greater on very high incomes such as those earned by the CEOs of large corporations.

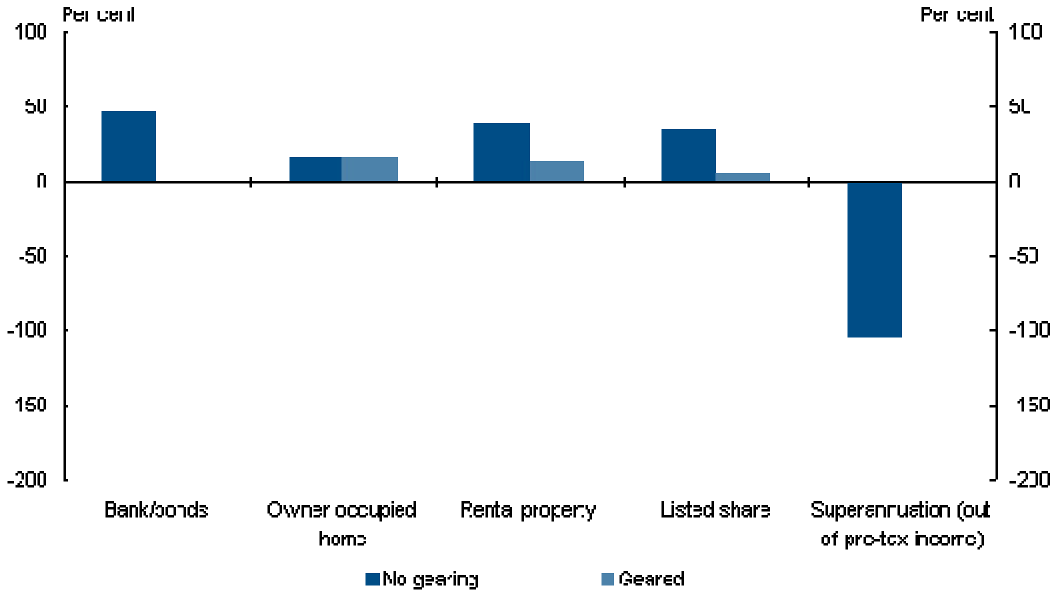
Gearing and negative gearing

Capital gains concessions interact with the full tax deductibility of interest expenses in the form of *negative gearing,*[7] whereby a taxpayer's other income is reduced by costs associated with an investment. Actually, the issue relates to *any* gearing rather than specifically to negative gearing, but only with negative gearing are deductions made against income from other sources.

Interest costs are deductible against income in the current year whereas CGT is levied only on realisation and not on accrued gains. Hence tax is deferred and the tax rate, in present value terms, is effectively lowered. But the tax problem associated with gearing is somewhat limited as long as nominal capital gains are fully taxed; with the 50 per cent concession however, gearing dramatically reduces the effective tax rate on returns from geared assets.

This is demonstrated in Treasury's (2008a) Chart 8.3, which shows that with 70 per cent gearing the nominal effective marginal tax rate (EMTR) on rental property is reduced from 47 per cent to 10 per cent and the rate on shares is reduced to five per cent. (Calculations for real tax rates in Treasury's Chart 8.4, not shown here, indicate a similar effect).

Figure 3: Nominal effective marginal tax rates (EMTRs) by asset type and financing arrangement



Source: Treasury 2008a, Chart 8.3.

Note: Calculated for an individual taxpayer on a 46.5 per cent marginal tax rate; assets held for seven years; inflation at 2.5 per cent; six per cent nominal return; gearing 70 per cent, not applicable to bank/bonds and superannuation.

[7] Gearing means borrowing to purchase an asset. Interest costs on the borrowing are deductible from ordinary income.

The only way to fully remove the tax advantage of gearing is to tax capital gains on an accruals basis so that any gain is matched with interest costs in the same year. Under this approach, negative gearing would not be concessional. This accruals option is explored later as is the case for disallowing negative gearing under the current realisation basis.

How we got here

Prior to 1986, CGT as such did not exist in Australia although short-term gains were taxed as ordinary income.[8] The reform package of that year introduced a tax on future gains but 'grandfathered' pre-1986 assets by allowing them to continue to appreciate tax-free. Short-term gains (gains on assets held for under 12 months) continued to be fully taxable. Indexation was applied to long-term gains so that only real gains were taxed. In addition, an averaging provision was introduced, designed to prevent 'bunching' of capital gains on realisation, which can send the taxpayer into a higher marginal tax bracket. Averaging allowed some manipulation; for example, by realising gains in a year when other income was low taxpayers could arrange to pay very little tax.

The 1999 Ralph Review of Business Taxation advocated a change to this regime to 'support a stronger investment culture among Australian households'. In particular it proposed:

- CGT to be halved, financed by the abolition of the averaging and indexation provisions and 'increased realisation of capital gains as a result of the reduced taxation' (Ralph Committee Report 1999b, p. 77). The reduction in the tax rate was seen as reducing the need for averaging.
- Rollover relief to be extended on scrip-for-scrip corporate acquisitions, a measure designed to stimulate takeover activity.[9]
- Indexation to be frozen but taxpayers with pre-existing assets had a choice of adopting the frozen regime or the new discount method. The case for ending indexation was that the discount method was more understandable. The Review judged on balance that 'a change in the form of concession to something more akin to the types of concession available abroad would … be more effective in attracting investors to Australian assets' (Ralph Committee Report 1999b, p. 600).
- Corporate entities did not receive the benefit of the 50 per cent concession. Corporations were anticipated, nonetheless, to 'receive major benefits from the reduction in the company tax rate to 30 per cent' (Ralph Committee Report 1999b, p. 77).
- Super fund earnings were to be taxed on two thirds of the capital gain, that is, at a tax rate of 10 per cent rather than the 15 per cent normally applicable. This concession was meant to compensate for the loss of indexation.

These recommendations were adopted in full by the Howard Government with effect from 30 September 1999. Overall, the changes were expected to be broadly revenue neutral, based partly on the expectation that realisation would be more frequent with a lower CGT rate.

In his review of these changes, Evans (2002) expressed dismay that the Ralph Review so heavily emphasised investment incentives and thus paid little attention to the equity criterion, which requires that income from different sources be treated equally. It is the fundamental raison d'être of the CGT.

[8] Some capital gains were taxed if they seemed to the High Court to be an artificial device for reducing tax.

[9] Rollover relief means that selling one asset in exchange for another of like nature does not create a capital gains event, for example selling shares in exchange for other shares in a takeover situation.

Evans concluded that 'the changes diminished the equity of the Australian tax system; are of dubious and unproved benefit as far as efficiency is concerned; and may have only a marginal impact on the simplicity of the regime … [T]he Australian regime now affords significantly different treatment to different forms or streams of income ...' (Evans 2002, p. 8).

On the subject of the 50 per cent concession, Krever argues: 'The rationale for the concession was never articulated and apart from its obvious effect—to reduce the tax burden for highest income individuals who are able to realise much if not most of their income as capital gains—it is difficult to posit a convincing purpose for the concession' (2003, p. 24).

ACOSS (1999) considered that the changes would fuel speculative property investment. It posted the following comments about the scope for tax avoidance opened up by the Ralph reforms:

A green light for tax avoidance:

What prominent tax accountants and financial commentators say about across-the-board cuts in Capital Gains Tax rates:

"Clearly the new CGT regime is inequitable and unjust and is an invitation to the kind of rorting that the Ralph Review was designed to stamp out." Ivor Ries, financial journalist, Australian Financial Review (AFR 23/9/99).

"Virtually every tax avoidance scheme before 1985, when CGT was introduced, was designed around the obvious incentive to turn income into capital and thereby avoid tax." Geoff Peterson, CGT specialist (AFR 16/7/99).

"You only have to do the numbers and they are radically improved: when you negatively gear you get an interest deduction at 48.5% when you are generating [capital gains] taxed at only half that rate." Michael Forsdick, Tax Partner, PricewaterhouseCoopers (AFR 23/9/99).

"Providers of investment products will increasingly try to devise products with prospects of capital gains coupled with some gearing." Michael Doolan, Tax Partner, KPMG (AFR 23/9/99).

"The new [employee share schemes] are likely to revolve around interest free loans. An executive may be given a $1 million loan to buy shares in the company. If after five years he sells the shares for $2 million, he will only pay tax on half the capital gain. That's a $242,500 tax bill compared with $485,000 if he had received $1 million [in salary]." Gordon Cooper, Tax Partner, Middletons Moore & Blevins (AFR 25/8/99).

Source: ACOSS 1999, p. 10.

Important issues for reform

Tax on realisation and 'lock-in'

The CGT applies only when the value of an asset is realised upon a sale—the asset can appreciate year after year and yet no tax applies unless and until a sale occurs. This is called a realisation basis. Under the comprehensive income tax benchmark, CGT would ideally be levied on an accrual basis, that is an asset would be revalued every year and the change in value would be added to (or, if there is a loss, subtracted from) the taxpayer's other income.

It is widely understood that taxing realisations rather than accruals creates a 'lock-in' effect[10] because there is an implicit interest-free loan from the government to the individual each year the tax is deferred, which discourages the taxpayer from selling assets as such sales terminate this implicit loan. This situation can create the perverse result that CGT rate reductions can actually lead to increased revenue in the short term as locked-in gains are released.

Whether such cuts result in increased revenue in the longer term is a moot point. Cross-sectional research suggests that revenues can be raised by lowering tax rates.[11] The Ralph reforms exploited this effect Time series studies, by contrast, 'almost universally found that gains were not very sensitive to tax rates' (Burman and White 2003, p. 376). Kenny (2005, p. 30) draws a similar conclusion.

It could be argued that all gains are eventually realised and that the revenue is more than compensated for the tax deferral because, as the asset appreciates, the tax liability grows at the same rate. However, Reynolds discounts the theory that 'all capital gains accruals are ultimately taxed during the life of the investor', suggesting that 'one-half of capital gains are held until death or donated to charity, thus escaping tax' (1999, p. 36).

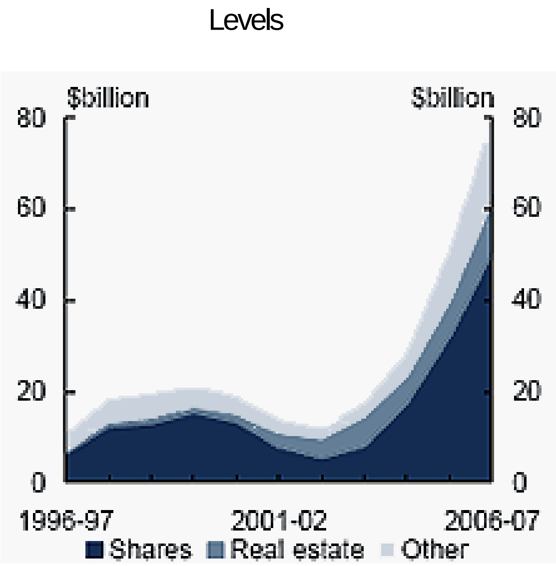
This underscores the importance of applying a deemed realisation upon death, that is valuing all assets of the deceased and levying tax on the assessed gain. Currently in Australia, death does not trigger CGT unless the asset is realised; if it is not realised, the cost base of the original acquirer is passed on to the beneficiary who only pays tax if and when the asset is sold. In this way the tax can be avoided in perpetuity.

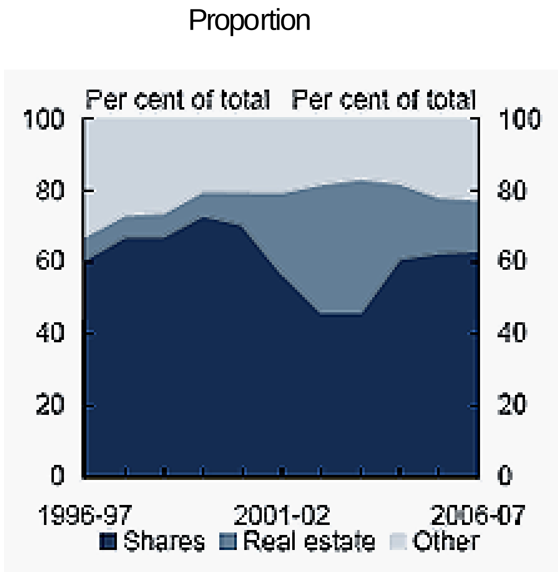
Lock-in could be avoided by taxing capital gains annually as they accrue. In the past, this has been deemed to be administratively infeasible, a view that that is open to question. On average, about 60 per cent of capital gains relates to shares (including unit trusts) for which values are readily ascertainable (see Figure 4). Most shareholders can now print out a day-by-day calculation of their share worth. A further 20 per cent of gains relates to property, which could be revalued annually by fairly simple computer models based on broad regional property price indexes. These are already used in revaluations for rates and land tax purposes.

10 See Fane and Richardson (2004, p. 2).

11 Reynolds (1999, p. 34) suggests (in relation to the pre-2000 system) that 'nearly all US studies of the lock-in effect imply that Australia's tax rate on individual capital gains is at least double the revenue-maximising rate'.

Figure 4: Total capital gains income by asset type (income-year basis)





Source: Treasury 2008c, Statement 5: Revenue, Chart A.

Note: These data are sourced from the CGT schedule, which taxpayers are generally required to complete if their net capital gains in the year are more than $10,000. On average, over 90 per cent of all capital gains by value are reported in the CGT schedule.

The more serious difficulties relate to the last 20 per cent of gains from sources like small businesses, closely-held private companies and unconventional investments like agricultural schemes, royalty streams and the like for which there is often no ascertainable market price. However, it does appear that accruals taxation could conceivably be applied to some 80 per cent of taxable assets with only modest difficulty from an administrative perspective, and special provisions could apply to the other 20 per cent.

In the US, an accrual basis applies to specific derivatives such as options, futures, forwards and swaps. The feasibility of a capital accretion tax, also called a *mark to market* tax, has received increasing attention in the scholarly literature in the US (Cnossen and Bovenberg 2001, p. 13, f/n 15 and 16) and is suggested as an Australian policy option in a recent paper by Burman (2009). Burman argues that accrual taxation, with losses fully deductible and full distribution of imputation credits, solves virtually all the problems confronting the current Australian tax system (2009, p. 12). The possibility of accrual taxation is also canvassed by Evans (2003, Ch. 2).

Problems with accrual taxation include the fact that taxpayers with gains may not have liquid resources to pay tax. Obviously, this is less of an issue where shares, bonds and managed investments are concerned because these are highly liquid, although people might resent being forced to sell. One option for dealing with the liquidity issue allows asset holders to carry over their tax owing, with interest, until the asset is sold (see Burman 2009, p. 13 and references therein). This is not concessional if the interest applied is at least equal to the long-term bond rate.

Tax deferral under a realisation basis creates economically inefficient tax-sheltering opportunities. For example, borrowing to invest delivers immediate deductions while tax on gains is deferred, possibly indefinitely. 'Such shelters are even more profitable if gains are taxed at lower rates than other income or indexed for inflation, which is tantamount to a preferential rate …' Further, 'a tax system based on realisation creates new complexities. Rules are needed to determine when a realisation event occurs. For long-held assets, especially ones that have been improved over time, there are issues of determining the taxpayer's costs against which to reckon any capital gain. Taxpayers must keep records for many years to substantiate their cost basis, and there are complex issues of which improvements to a property qualify as capital …' (Burman and White 2003, p. 375).

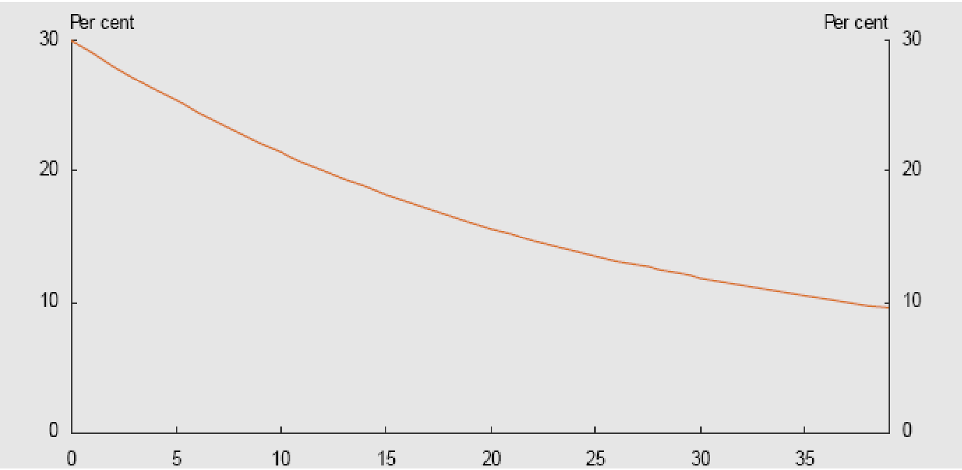
It follows that capital gains taxes, partly because of their realisation basis, require a disproportionate amount of legislation and rules relative to the revenue they raise. Some critics have used this as an argument for abolishing CGT altogether. But it is necessary to remember that the role of CGT is only partly to raise revenue directly; its more important role is to buttress the income tax system and promote equity.

Because some items of capital gain, notably shares, can realistically be taxed under an accrual system, the possibility arises of using a part accrual and part accretion tax. For example, for the Netherlands, Cnossen and Bovenberg (2001, p. 13) proposed taxing stocks, bonds, derivatives and debt claims under mark-to-market while taxing real estate and small businesses on a realisation basis combined with an equalisation formula designed to approximate the effect of accrual taxation (see below).

Adjustment for tax deferral

Taxing capital gains when they are realised on sale rather than each year as they accrue allows for tax deferral, which creates an implicit interest-free loan from the government and reduces the effective rate of CGT. For an asset appreciating at 10 per cent a year and held for five years, deferral under a realisation CGT reduces the effective nominal rate for a company or individual taxpayer on the standard rate from 30 per cent to 25 per cent; if the asset is held for 10 years, the effective rate reduces to 20 per cent and for 35 years, to 10 per cent. Figure 5 below illustrates this effect.

Figure 5: Nominal EMTR on a capital gains tax asset by holding period (years)



Source: Treasury 2008b, Chart 6.6, p. 148.

Several ingenious proposals have been advanced for adjusting the tax rate on realisation to take account of deferral gains over the life of the asset. Put simply, the tax rate rises over time and the greater the gain in the asset price, the greater the rise in the tax rate. Some options are described in the Meade Report (1978), Benge (1997) and Fane and Richardson (2004); these also tend to reduce 'lock-in' as the gains from further holding are reduced.

The downside of these sorts of proposals is that the necessary calculations are complex and the rationale for adopting them would be almost incomprehensible to many taxpayers (and lawmakers). Italy in 2001 is the only country that has experimented with this approach, adopting a complex adjustment called 'the equalizer', which also employed some elements of accrual taxation.

Although the revenue performance of the Italian experiment was good, according to Alworth et al. '… the rapid build up of strong "anti-equalizer" lobbies helped to erode any political support for a tax that was increasingly perceived to be inequitable, expensive and inefficient'. The Italian approach may have been unnecessarily complicated: 'In hindsight, the existence of three different types of calculation may have been an important factor triggering these criticisms' (2003, p. 215).

It is therefore difficult to generalise from the Italian experience but it seems likely that it would be almost impossible to garner political support for an equalisation formula in Australia, given the obstacles to popular understanding. Another argument is that deferral benefits can be negated by inflation and, under plausible parameter values, these two effects broadly cancel out.

Inflation adjustments

The pre-1999 Australian capital gains regime included an inflation adjustment. The real gain was computed by subtracting from the sale price an adjusted purchase price consisting of the nominal purchase price raised by a factor reflecting the Consumer Price Index (CPI) movement over the holding period.

Inflation adjustment may not now be considered as pressing a problem as it was in 1986 when inflation was higher. This is an issue that arose during the McLeod Tax Review in New Zealand (McLeod Committee 2001a, 2001b). The OECD (2000) considered that 'indexation is unnecessary as long as the current low inflation rate is sustained' but the Review demurred, noting that even low rates of inflation can significantly distort effective tax rates (McLeod Committee 2001a, p. 34). This and other concerns about complexity, lock-in and investment distortions led the Review not to recommend a conventional CGT for New Zealand but instead a novel method based on imputing an annual return to capital investments (see below).

The Ralph Committee was agnostic about inflation adjustment but held that a simple discounting approach would be more widely accepted. Over longer periods, the discount system discriminates against long-held assets with low capital appreciation in favour of short-held assets with high appreciation.

The problem with indexing the CGT is that, in common with other reforms to partially index the tax system, there may not be a net benefit in the absence of a more comprehensive reform. For example, with capital gains indexed (in the 1986–1999 regime) and full deductibility of nominal interest, there continued to be a tax benefit for gearing and especially for negative gearing. This led to a brief disallowance of negative gearing under the Hawke/Keating Government in 1985, a change which was reversed in 1987 when rents in Sydney began to rise rapidly. However, there may have been other reasons for the rise in rents (see the section, 'Capital and other losses').

A further problem with indexation is that, when combined with tax deferral until realisation, it results in a distortion towards those investments likely to yield long-term capital gains and hence away from taxable investments like bonds, which have high nominal yield but little capital gain. In some low-inflation scenarios, the non-indexation of capital gains could be a broad offset to the deferral benefit under a realisation CGT.[12]

It follows that indexation of CGT may make limited sense in the absence of broader measures to index the tax base. These might include, for example, restricting interest deductions to the real (not

[12] Assume an aggregate capital stock of $1 trillion yielding a five per cent real and 7.5 per cent nominal gain. Assume half the yield is taxable income and the other half capital gain; the stock is turned over at the rate of 15 per cent per annum. Assume a 30 per cent tax rate. Taxable income each year = $37.5 billion plus $5.5 billion = $43 billion and tax payable = $14 billion. If real income were fully taxed on an accrual basis, taxable income would be $50 billion and tax $15 billion.

nominal) interest cost. If accrual taxation of capital gains were contemplated, the indexation issue would perhaps become more pressing.

Does light taxation of capital gains increase economic growth?

The Ralph Review of Business Taxation certainly considered this to be the case and designed its recommendations to 'support a stronger investment culture among Australian households'. Indeed, the chapter dealing with capital gains is called 'Incentives for investing' and the overview, 'Rewarding risk and innovation' (Ralph Committee Report 1999b). The Review argued: 'Australia taxes capital gains … more harshly than other countries in our region competing for international investment. The competition for domestic and international capital for investment is strong and likely to become more intense. Failure to attract investment funds will mean lower levels of economic activity and fewer jobs' (p. 77).

The problem with this sort of argument is that it can be used to support almost any concession and, indeed, it has been. The ideal tax system would apply a very similar effective tax rate to all the different avenues of investment because considerably more economic distortions arise from the different tax treatments than from the weight of taxes on capital in general. Empirical evidence, while mixed, tends to suggest that aggregate savings are relatively unresponsive to the net (after tax) interest rate (Burman and White 2003, p. 361). Also, concessions for saving and investment can reduce government saving and offset any private savings benefit.

If it is supposed that aggregate investment is inadequate, one option is to reduce the broad rate of tax applicable to investment rather than to distort the tax system in favour of particular types of investments yielding capital gains. Taxes on capital can be lowered by changing the aggregate tax mix towards expenditure taxes such as the GST and payroll tax[13] and away from income taxes. Another option is the direct expenditure tax, although this also creates difficult issues. Burman and White note 'some of the most plausible arguments for exempting capital gains from tax in New Zealand are really arguments for lightening the tax burden on capital generally' (2003, p. 371). Since increasing the GST is one of the options ruled out in the terms of reference for the Henry Tax Review, it is assumed that the government does not desire to change the tax mix in this manner.

Wyatt et al. (2003, p. 7) compared effective tax rates on capital gains in Australia with those of its regional neighbours and trading partners. They found that the Ralph reforms 'have achieved their objective of making Australia's taxation system more internationally competitive' but Australia's CGT rates are still relatively high. The issue here is whether Australia should even attempt to match the concessional treatment of capital gains found in most other countries. There is also the issue of how much international competitiveness really matters since corporations already pay full tax on capital gains and foreign portfolio investors have not been taxed on their capital gains from Australian share assets since 2006. Foreign investors in real property could be specifically protected from changes to the CGT.

The promotion of risk-taking is a reason sometimes advanced for taxing capital gains lightly. Burman demonstrates that a properly-designed CGT, with gains taxed on accrual and losses fully deductible against other income, is neutral with respect to risk (2009, p. 7; see also Burman and White 2003). However, the actual CGT has different design features and, in particular, only allows losses to be offset against realised gains. This creates the risk that taxpayers will carry forward capital losses that cannot be deducted for several years, thus reducing their present value and creating a tax bias

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[13] It is not obvious that payroll tax is a form of expenditure tax but, in fact, it can be shown to be economically equivalent under certain assumptions (Meade Committee, 1978; Treasury 2008a, Appendix B).

against risk. Burman (2009) cites US studies suggesting that the majority of such losses are, in fact, usable within two years but this may not be true in the aftermath of the current global financial crisis. There may be little that can sensibly be done about this situation as the current circumstances are exceptional.

Capital and other losses

If CGT were applied in full to accruing capital gains, the logic is that accruing capital losses should be fully deductible in order to make the tax system neutral with respect to the risk of an investment. However permitting full deductibility of capital losses in the context of a realisation regime would allow taxpayers to effect loss-making realisations while continually deferring tax on their profitable investments. There is no real solution to this problem without a tax on accruals but it is less of an issue if losses are not offset against normal income but rather are allowed to be carried forward and offset against future capital gains. That is the current situation.

There is a further issue with gearing, that is borrowing to invest and claiming a tax deduction for the interest[14] but, again, it would not be a problem with full taxation of accruing capital gains. However, allowing full deductibility of nominal interest costs while taxing only half the capital gain creates a severe distortion of investment incentives as demonstrated in Figure 3, which shows the low effective tax rates on geared investments. In aggregate, direct property investment in Australia is lightly taxed and, as Figure 3 shows, gearing is the major reason for this. A partial solution is to fully tax nominal gains but, because costs receive an immediate tax benefit whereas tax on gains is deferred, this situation will continue to deliver a net gain from gearing.

A more comprehensive solution would disallow negative gearing losses, notably those arising from interest costs and depreciation. These losses, instead of being deducted from normal income, would be carried forward to offset future capital gains, thus generating significant revenue.[15] This regime applied briefly in Australia from 1985 to 1987 when rental property losses were quarantined and carried forward to be offset against any future realised capital gain. In 1987, negative gearing was re-introduced, partly in response to a perceived decline in rental property investment.

This impact on investment and rental costs has not gone unchallenged. 'It is useful to examine what happened when negative gearing was abolished for the 2 years between 1985 and 1987. During this period, there were large rental increases in parts of Sydney. However, in the rest of Australia there was no real (after inflation) increase in rents. In many cities there were real decreases in rents … Is what happened in Sydney due to the abolition of negative gearing, or some other factor?' (Hanegbi 2002, p. 8). Other explanations include rising interest rates at the time and diversion of investment funds into the share market boom.

Allowing a tax deduction for negative gearing (and indeed the capital gains discount) is a blunt solution to problems of housing affordability as it makes rents cheaper for rich and poor tenants alike while causing general increases in house prices to the detriment of those seeking to buy. Targeted interventions to support low-income housing, raising rental assistance for example, make more sense. Negative gearing should be disallowed.

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[14] Interest costs are of course a legitimate business expense. The point is that their deductibility lowers the effective tax rate on capital income in the absence of accruals taxation of capital gains.

[15] Hanegbi (2002) provides an estimate of $2 billion but the source is not fully reliable. Increases in rental subsidies for private tenants would probably be an offset.

Averaging of capital gains

Taxing capital gains on realisation can give rise to lumpiness in the time pattern of taxable income, which can be unfair if it takes a taxpayer into a higher-than-normal marginal tax bracket. The 1986 system resolved this by allowing averaging, a mechanism that provided for one-fifth of the assessed gain to be added to other income in the relevant year and the extra tax calculated on that amount. This was then multiplied by five to compute the CGT liability.

This system was open to exploitation. By realising gains in years when other income was low, CGT could be artificially minimised. The Ralph Review considered that the 50 per cent discount sufficiently resolved the problem of lumpiness and averaging was abolished. If, however, the 50 per cent discount were to be abolished, a specific reform advocated in this paper, consideration would again need to be given to the averaging issue.

Taxation of imputed gains

In New Zealand, the 2001 McLeod Tax Review issues paper rejected a new CGT[16] and instead proposed taxing capital income using the 'risk-free return method' (RFRM). In essence, investments are assumed to receive a real risk-free return, calculated at that time as four per cent per annum (the then real interest rate on a one-year Treasury bill). This amount was to be added to other taxable income to calculate tax liability. It is not clear whether interest and dividend income flowing from the same investment would continue to be taxable, but one assumes not.

This approach was favoured because it sidestepped the complexity of an explicit CGT and the associated issues of indexation and realisation versus accrual (McLeod Committee 2001a, ch. 2). In the event, the imputation option was not taken up by New Zealand, nor was a CGT introduced. The Netherlands adopted an imputation scheme in 2001 (Cnossen and Bovenberg 2001), also using an imputed four per cent earnings rate. However, this imputed income is taxed at a flat rate of 30 per cent above an exempt amount so is not integrated with the ordinary income tax.

Australia has had a similar system in the past in the form of the asset component of the pension means test. Under the pre-1976 'merged means test', actual income from capital sources (including capital gains) was disregarded but was instead imputed at a 10 per cent annual rate. This was added to income from employment and superannuation pensions to give 'means as assessed', which was the basis for the pension calculation. The 10 per cent figure seems high as an estimate of the average real return from capital—historically it has been about five per cent—but it was originally assumed that the asset could be invested in an annuity at 10 per cent.[17] Others have suggested an imputation approach as an overall solution to the problem of measuring and taxing real capital income (see for example, Dixon 1985).

Imputation is an interesting option that sidesteps many of the problems associated with a conventional CGT but it does have a disadvantage—it is kind to assets earning more than the assumed real rate and unkind to assets earning less. In practice, this means that it disadvantages unsophisticated savers and advantages those who receive good investment advice and can allocate a proportion of their assets to growth investments.

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[16] New Zealand has no CGT as such, although some capital gains are treated as normal income.

[17] Currently, an indexed annuity is likely to yield a 65-year-old beneficiary less than six per cent. Under the current means test, the income and asset test operate separately and the pension rate applicable is the lower of those indicated by the two tests. The implicit imputation rate in the asset test is now 9.75 per cent, but the test is actually more generous than the old merged means test as it is now possible to receive substantial income and possess considerable assets and still be eligible for some pension.

Evidence from stock markets suggests that the historical risk premium has been at least as large as the risk-free rate of return, and possibly much larger. The long-term equity risk premium is in the order of four to five per cent per annum and the risk-free return less than three per cent (that is, the combined return is over seven per cent). Thus, the RFRM could exclude half of the real return to risk assets as compared with accrual taxation. The simple solution, to impose a higher imputation rate, disadvantages unsophisticated savers who keep their money in low-yielding bank accounts. A dual imputation rate is another possibility, much like the current deeming rates in the pension means test.[18]

Another problem with the imputation method is that it imposes a tax liability unrelated to cash flows and can therefore result in a tax liability even in years when the asset declines in value. It would be difficult to tell a taxpayer that the imputed income on the elevated purchase price of their asset is to be fully taxed when the asset value has actually declined 50 per cent (as in the current share market). Burman notes that: 'Even though the tax is fair and efficient, *ex ante*, it would be difficult to sustain it *ex post* (although somehow the Dutch manage to do it)' (Burman 2009, p. 14).

In their review of the McLeod Committee final report, Burman and White (2003) argued that the 2001 Tax Review in New Zealand dismissed too readily taxing gains on a realisation basis and concluded that problems such as lock-in and loss limitations appear to be fairly modest based on available empirical evidence. On balance, they argue that taxing gains on a realisation basis has a number of advantages over the RFRM proposed by the McLeod Committee (p. 355).

Compliance costs

There is no doubt that the compliance costs of CGT are high since it is inherently a complicated tax and imposes substantial record-keeping costs.[19] For example, if a taxpayer buys shares and then participates in a dividend re-investment plan, both the original investment and any subsequent purchases of small quantities of shares form part of the cost base of the asset. Evans (2003) attributes part of the cost burden in Australia to the complicated system of relief for small business and part to the inclusion of taxpayers with small liabilities. He notes that in 2000 about 10 per cent of taxpayers were subject to CGT but it provided only two per cent of total income tax receipts. By contrast, in the UK less than one per cent of income tax payers had a CGT liability, reflecting the high exempt amount in the UK version of the tax.

Evans argues that 'A disproportionate amount of time and effort is spent in Australia on extracting small amounts of tax on capital gains from a large number of such individuals who have minimal gains' (2003, p. 217). He shows that in the 1999–2000 tax year, more than one third of the individuals affected by the CGT regime (roughly 350,000 individuals) contributed only five per cent of the actual capital gains tax collected.

In order to lower compliance costs in the Australian system while risking the loss of relatively little revenue, it would be possible to exempt a certain amount relating either to the actual gain itself or to gross asset realisations.[20] In addition to reducing compliance costs and aiding political support for reform, such an exemption would have only a small effect on equity since the bulk of capital gains

[18] Financial assets are deemed to earn interest at a rate that varies from time to time and banks have special accounts for pensioners which pay this deeming rate. The deeming rate is normally much less than the implicit deeming rate in the pension asset test, which is 9.75 per cent.

[19] For a comprehensive discussion, see Evans (2003, ch. 3). Other taxes also impose large collection/compliance costs, for example Fringe Benefits Tax.

[20] Evans suggests that: 'Individual taxpayers should not be required to return capital gains where the amount of gains in the year were less than the threshold (say, $7,500) and the amount of capital proceeds from all assets in the year was less than double that amount ($15,000)' (2003, p. 218).

would still be taxable; recall from Table 1 that the lowest 50 per cent of income earners received only 13 per cent of all capital gains in 2005–06.

Small business concessions

Evans notes: 'Australia's policy and technical experience with small business concessions has been variable and confusing over the years. Initially no special treatment for the small business sector was to be afforded within the CGT regime. This changed almost immediately when one small concession was introduced in 1985. By 1997 there were three specific concessions, with messy legislative provisions that were virtually unworkable. "Rationalisation" and "reform" in 1999 has led to an increase to four in the number of special provisions for the small business sector, but no less concern about the workability of the legislation. Practitioners are still, in the main, confused, and see the small business concessions as a major source of systemic compliance costs in the Australian CGT regime'. (Evans 2003, p. 210).

Evans is sympathetic to rollover relief and the small business retirement exemption ($500,000 lifetime limit), but argues that '… [T]here is little policy justification for the 15 year retirement exemption or for the 50% active business assets reduction. They distort economic behaviour, give rise to yet more inequities, and clearly add to the complexity of the CGT regime' (2003, p. 222). In his view, the remaining two concessions should be extended to all business to reduce complexity (2003, p. 223).

Small business owners enjoy the same access to deductible superannuation contributions as do employees. Accordingly, the recommendation is that all small business concessions apart from the rollover concession be abolished, with the latter sensibly being extended to other business.

Including owner-occupied housing in the tax base

Owner-occupied housing is taxed at the local government level using rates, which are normally related to the unimproved value of the land. Many researchers have seen such housing as a potentially rich source of additional revenue. Certainly housing is taxed much more lightly than most other investments (refer to Figure 3).

If owner-occupied housing were to be included in the CGT base, the revenue impact would be very large—a net $29 billion per annum on Treasury estimates. However almost no overseas countries include owner-occupied housing in the capital gains base except for Japan (at rates between 10 and 20 per cent depending on length of holding); Spain (which exempts if the owner is at least 65 years of age and also provides rollover relief); and the US (which allows a threshold and also mortgage interest deductibility) (Warburton and Hendy 2006, Appendix 6.2).

There is a clear conceptual case for including owner-occupied housing as part of a comprehensive broadening of the income tax base, an exercise that could raise considerable revenue even if, as is appropriate, rollover relief were permitted.[21] Housing is a rational investment like any other and, with financial innovation, equity can be released from housing through such means as home equity loans. The concessional treatment of housing discriminates severely against renters, who must pay more tax to make up the shortfall. It also drives up property prices.

Housing assets are strongly correlated with income and other wealth and the exemption for housing therefore bestows large benefits on the already well-off. It is also inefficient; it distorts housing patterns towards owner-occupancy despite an increasingly mobile society and it results in over-

[21] Such relief should not be indefinite. There would need to be a deemed realisation on death.

investment in the housing sector.[22] These inefficiencies will be intensified by the proposal in this paper to abolish the 50 per cent capital gains discount because the difference in tax treatment between housing and other assets will be exacerbated.

Kenny argued that the 'Australian housing price bubble appears to be partially fuelled by preferential CGT treatment as investors sought to take advantage of the personal residence exemption, CGT discount and negative gearing. Relevantly, Sandford noted that preferential CGT treatment for housing creates inflated prices' (Kenny 2005, p. 12). However, the political obstacles to including owner-occupied housing in the tax base are formidable.

The Australian Taxation Review Committee (Asprey Committee) considered including houses in the CGT in its 1975 review but ruled it out on the grounds that 'the taxpayer's principal residence should be considered in a different light to his other assets, particularly in a society such as ours where home ownership is so highly valued and encouraged. A home is regarded as more than simply an investment' (Asprey 1975, p. 426).

There was also concern that taxing housing would inhibit labour mobility and that record-keeping would be a burden with records to be kept of all capital improvements. The Asprey Committee 'explored partial exemption and roll-over mechanisms, and considered both would serve to correct the tendency for resources to be diverted into overlarge houses. But the committee also considered that the roll-over would actually increase the problems of administering the tax, whilst the partial exemption would still leave too many administrative problems. As a result, and in rather summary fashion, both possibilities were rejected in Australia in 1985' (Evans 2003, p. 198).

In New Zealand, the 2001 McLeod Review issues paper proposed including owner-occupied housing in the recommended RFRM. The equity component of a house would be assumed to earn an average capital gain of four per cent per annum and this amount would be added to the owner's taxable income. Considerable revenue was projected from this tax. Although this was recommended as an alternative way of taxing capital gains, it amounted to a modest tax on imputed rent or, equivalently, an annual wealth tax on the equity component of housing.[23]

Including capital gains in a more comprehensive way and introducing a tax on imputed rental income of owner-occupied housing were two important recommendations made by the OECD in its bi-annual report on New Zealand in 2000 (OECD 2000, cited in Burman and White 2003, p. 358). Housing amounts to 70 per cent of total assets in New Zealand, a high proportion by OECD standards.

The final report of the McLeod Committee noted that the housing tax issue was highly controversial and the overwhelming response was negative. Neither the proposal as it related to housing nor the broader proposal for an RFRM was taken up. In respect of housing, the main issues were:

- home ownership was viewed as a social good
- the tax might impose cash flow problems
- housing is already taxed by way of rates
- there was a concern that the tax could be avoided and be costly to administer (McLeod Committee 2001b, p. 30).

[22] It also pushes the housing mix away from rental.

[23] Strictly speaking, an imputed rent tax assumes a certain rate of gross rental return and allows deductibility of interest and other costs. The alternative is to impute a real return to the equity component of the house. This has the great advantage of being simpler and less sensitive to the level of inflation and interest rates. Historically, the total real return on housing in Australia is five to six per cent as compared to the four per cent risk free rate proposed by the McLeod Committee in the New Zealand Review.

Whatever the merits (or otherwise) of these arguments, the imposition of what amounts to a wealth tax on the equity component of housing was never likely to be an easy matter.[24] Among the OECD countries that still levy annual wealth taxes, a diminishing band, it is common to find that:

- exemptions are numerous and thresholds are high
- valuations are often substantially below real market values
- there is taxpayer resistance
- owner-occupied housing is generally not included or included concessionally.

In the Netherlands for example, under a system quite similar to the RFRM proposed for New Zealand, the imputed income from owner-occupied housing is 1.75 per cent per annum as compared with the four per cent imputed for financial assets, and this income is taxed at a flat rate of 30 per cent.

Conclusion

It appears that the obstacles to full taxation of nominal capital gains at marginal income tax rates are not insuperable and would be a major anti-avoidance measure, blocking in particular the manipulation of executive salary packages to effectively slash income tax. It would prevent the situation, complained about by US billionaire Warren Buffet, where his income, mainly from capital gain, is taxed more lightly than his secretary's salary.[25] It would also stop the diversion of investments into forms yielding capital gain rather than income and would redirect some of the enormous energy and skill, which goes towards sheltering income from tax, into more productive uses. It would also diminish the disproportionate interest in short-term share and options prices that underlie the tax-effective salary packages of the typical CEO.

Lock-in would be exacerbated by the proposal to fully tax capital gains but the evidence from the Keating reforms suggests that this was not a major issue and would unwind itself over time. It would be greatly helped if there were a deemed realisation on death. Some form of averaging provision might need to be re-introduced.

There is no case for re-introducing indexation of the CGT. Indexation of gains, while allowing full deductibility of nominal interest costs, lowers effective tax rates on geared investments to well below the notional tax rate. Although the conceptual ideal is a tax on real income, this should not apply to the CGT in isolation; it needs to apply comprehensively throughout the income tax base.

Taxing capital gains at rates of up to 46.5 per cent will raise the cry that savings and investment will be discouraged. But if this is a concern, the solution does not lie in the lighter taxation of certain favoured forms of capital income but in reform of the way capital income is treated in general. Reformers in the Schanz-Haig-Simons tradition have come to one conclusion: tax reform should aim at broadening the tax base, eliminating loopholes and exemptions and cutting rates across the board. Outside this tradition, a second set of broad options includes moving towards an expenditure tax base but even if the role of income tax in the tax mix is lightened, the policy recommendation of no preferential CGT treatment is the same.

[24] Ironically, the McLeod Committee rejected the notion of a general wealth tax for New Zealand (McLeod Committee 2001, p. 32) while favouring the RFRM, a tax on imputed income that has precisely the same effect.

[25] Buffet's tax rate was 18 per cent on $US47 million income (year not stated) compared to his secretary's rate of 32 per cent at http://www.washingtonpost.com/wp-dyn/content/article/2007/06/27/AR2007062700097.html

Consideration could also be given to taxing easily-valued assets on a full annual accrual basis. If this were done there might be a case for an equalisation formula to apply to those assets taxed only on realisation. The case for indexation is also stronger. Obviously, this set of reforms is relatively complex but, in the view of some well-informed commentators like Burman (2009), an accrual basis has significant benefits.

Pre-1986 assets need to be brought into the CGT system by applying a valuation date and a mechanism for resolving complicated valuation issues.

Ideally, owner-occupied housing would be included in the tax base. This would reduce tax discrimination against renters (who would benefit from the general tax cuts thus financed) and enhance housing mobility. The potential revenue is considerable, $30 billion per annum, but the political obstacles are obviously substantial. They could be reduced by allowing rollover relief on moving house and possibly by applying tax only above a threshold, for example twice the median house price of $400,000.[26] A further option is to apply a discount to capital gains from owner-occupied housing akin to the current 50 per cent discount.

Finally, the absurd and inequitable small business concessions should be abolished. Small business owners have the same access to superannuation tax concessions as do employees using salary sacrifice, with deductibility for up to $50,000 of contributions per annum. Additional retirement concessions appear unwarranted. However, the rollover concession on the sale of a business should remain.[27]

There are several long-term solutions to taxing capital gains properly. In the income tax tradition, the Burman proposal for accrual taxation is one option; the Dutch method of imputing an average return to capital investments is another and this also has the advantage of not requiring inflation adjustments. A second set of options may be to move away from income tax and towards a *direct expenditure tax* of the cash-flow type to be levied at progressive rates. Under this tax, investments are fully deductible in the year they are made and realisations fully assessable. No long-term record keeping is required. The cash-flow tax removes the difficult valuation problems involved in taxing gains as they accrue and, for business, in measuring economic depreciation. It also removes the need for inflation adjustments and provides automatic rollover relief when realisation of an investment is rolled into another asset of a similar size, thus creating no net tax liability.

The effect of a cash-flow tax is to leave the return on an investment equal to the underlying real yield on the asset it finances and thus to tax capital income only lightly.[28] This tax is very kind to capital accumulation and would probably need to be supplemented by an annual wealth tax and/or inheritance tax as proposed, for example, by the Meade Committee in the UK (1978). Australian experience with the pension means test shows that an annual wealth tax is administratively feasible and leads to equity benefits. Ironically, the combination of an expenditure tax and an annual wealth tax may prove to result in a more robust and more easily administered form of comprehensive income tax, one which resolves some of its more intractable problems, including those relating to the CGT.

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[26] The median house price is about $450,000 but this does not include units, which have a lower median price. A rough estimate of the weighted average is $400,000.

[27] Evans (2003) makes a strong argument that the small business rollover should be extended to all businesses. This would do away with the complex rules needed to define a business as 'small'.

[28] In theory, there is no tax on capital income; savings yield equals investment yield. In fact, this equality is vitiated by progression in the tax rate structure as consumption later in life may be taxed at rates different from the tax remitted when savings were made. Also, such a tax falls on economic rents returns greater than the economy average. Thus a direct consumption tax of the cash-flow type, unlike a pre-paid expenditure tax (wage tax), creates a form of hybrid income/expenditure tax.

Appendix A: Definitions

Accretion tax	This is a tax which falls on the annual change in the value of an asset. The tax would also require the periodic valuation of non-traded securities, such as stock options issued to management, using option pricing techniques.
Accrual tax	Tax on the change in value of an asset over the course of a year. Also called an accretion tax.
Cash-flow tax	This is one of the forms of expenditure tax. A cash-flow tax would be imposed on the net cash flow of businesses, not net income or profits. For individuals the tax base is income less net saving—this is equal to consumption.
Capital gain	A capital gain is an increase in the value of an investment asset measured either over a year (an accrual basis) or at the time the asset is disposed of (a realisation basis).
CGT	Capital Gains Tax
Expenditure tax	An expenditure tax is one which leaves the return on an investment equal to the economic yield on the underlying asset it finances. In effect, there is no tax on capital income. The two types of expenditure tax are: a pre-paid expenditure tax based on direct taxation of labour income with an exemption for capital income (that is a payroll tax) a post-paid expenditure tax based on the taxation of cash flows from wages and investments, with deductions for net savings. An expenditure tax can be direct such as the cash-flow variant, which can have a progressive structure of marginal rates, or indirect such as the GST or payroll tax.
Income tax benchmark	Describes the standard taxation arrangements applying to personal and business income, in which savings are made from after-tax income and earnings from savings are taxed at full marginal tax rates based on the income of individuals in any one financial year. Under a comprehensive income tax benchmark, accruing real capital gains should be taxed each year .
Mark-to-market tax	Also known as an accruals tax. Companies and individuals would be required to mark to market their publicly traded property and derivatives. Tax is assessed on the net annual gain or loss.
OECD	The Organisation for Economic Co-Operation and Development
Post-paid or cash-flow expenditure tax	Under the post-paid expenditure tax, also known as the cash-flow expenditure tax, investments are deductible but realisation of investments creates a tax liability unless they are rolled over into another investment.
Schanz-Haig-Simons definition of income	The income tax benchmark is based on the Schanz-Haig-Simons definition of income. An entity's income is defined as the increase in the entity's economic wealth (stock of assets) between two points in time, plus the entity's consumption in that period. Consumption includes all expenditures except

	those incurred in earning or producing income.
Tax concessions	Termed 'tax expenditures' as they have a similar policy and fiscal impact as expenditures, these involve granting certain taxpayers, activities or assets more favourable tax treatment than that applicable to taxpayers generally.
Tax expenditures	Australia uses the revenue forgone approach to measure tax expenditures. This approach measures the difference in tax paid by taxpayers who receive a particular concession relative to similar taxpayers who do not receive the concession. It compares the current or prospective treatment to the 'benchmark' treatment, assuming taxpayer behaviour is unchanged. The setting of the benchmark against which tax expenditures are measured involves an element of judgement. Two guiding principles in setting the benchmark are that a standard tax treatment should apply across similar taxpayers or transactions and that the benchmark may incorporate structural elements of the tax system, such as the progressive personal income tax rate structure and the nominal income tax approach. The estimated tax expenditures would differ considerably if measured against a real income tax benchmark or an expenditure tax benchmark.

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