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Griffith Law School Research Paper No. 20-4

John Minas
Brett Freudenberg

Australia's 50% CGT Discount: Policy Oversight?

Excerpt

Australia's 50% CGT Discount: Policy Oversight?

John Minas* and Brett Freudenberg**

Abstract

Since its enactment in 1999–2000, the 50% capital gains tax (CGT) discount has become an entrenched feature of the Australian tax system. The CGT discount is effectively a tax rate preference that, we argue, remains in place despite its tax policy shortcomings. These include that the CGT discount is inequitable from the perspective of horizontal and vertical equity, and it is inefficient in that it may encourage an overinvestment in assets that produce most of their return in the form of capital gains. This article is a critique of the CGT discount which draws on a chronologically organised analysis of the views and commentary on the CGT discount from individuals and organisations outside of government. Views and commentary on the CGT discount are sourced from the news media, submissions to government discussion papers, and other publicly available information. This article critically evaluates the policy basis and evidence for the 50% CGT discount and is, in part, concerned with whether there is an overall justification for the preference. It is argued that the justifications made by policymakers in favour of the CGT discount, at the time of its enactment, lacked sound tax policy foundations. It follows that the case for the CGT discount continuing in its current form is diminished.

* Senior Lecturer, Tasmanian School of Business and Economics, University of Tasmania; Adjunct Research Fellow, Griffith Law Futures Centre, email: john.minas@utas.edu.au;
** Professor, Griffith Business School, Griffith University, email: b.freudenberg@griffith.edu.au

This article was accepted for publication on 19 November 2019

1 Introduction

The focus of this article is upon the 50% capital gains tax (CGT) discount for personal taxpayers in Australia. Some of the commentary on the CGT discount has argued that political considerations have been of more importance in the decision to enact and retain it in comparison with the principles of good tax policy. This article sets out and analyses the commentary on the CGT discount since the time of its introduction in the 1999–2000 tax year.[1] Notwithstanding that there was some opposition to, and criticism of, the CGT discount at the time of its enactment, the discount appears to have attracted increased scrutiny in recent years. This has included calls for reform of the 50% CGT discount in a number of articles in the news media, as well as in several submissions in response to the 2015 '*Re:think*' tax discussion paper. It is important to critically evaluate the policy and the evidence for the 50% CGT discount and consider whether there is an overall justification for this tax preference. Through this analysis it is argued that the case for the CGT discount continuing in its current form is diminished.

Following this introduction, Section 2 sets out the background to the article. Section 3 reviews the literature on CGT, including the arguments in favour of and against capital gains rate preferences. Section 4 is a review of the commentary on the CGT discount in the years after its enactment. Section 5 sets out the article's conclusions.

2 Background

Australia's taxation system has included a comprehensive regime for taxing capital gains since 20 September 1985. The 1975 *Report of the Taxation Review Committee* (also referred to as the 'Asprey Report') first recommended a CGT for Australia. One of the primary arguments for a CGT outlined in the Asprey Report was that in a tax system such as Australia's, in which ability to pay is the primary test of liability, it would be inequitable to exempt capital gains from tax.[2] A similar argument was iterated in 1985 *Draft White Paper*, which identified that a tax system without a CGT breaches the principles of horizontal and vertical equity, and distorts investment decisions, by encouraging investment in assets with returns in the form of capital gains over other types of returns.[3]

Australia's capital gains provisions were originally enacted into the *Income Tax Assessment Act 1936* (ITAA36) and subsequently rewritten as part of the Tax Law Improvement Project in the 1990s. In Australia, taxpayers are liable for income tax on their net capital gains under s 102-5(1) of the *Income Tax Assessment Act 1997* (ITAA97), which operates to include the net capital gains of taxpayers in their assessable income.

From 20 September 1985 until 21 September 1999, the capital gains of Australian personal taxpayers were taxed at a taxpayer's marginal income tax rate.[4] From 21 September 1999, the 50% CGT discount has applied to capital gains where the taxpayer has held the

1 Although the article considers the views of commentators who have expertise in CGT, the scope of the commentary in the article is not limited to experts.

2 Taxation Review Committee, *Full report* (31 January 1975), 414–415.

3 Commonwealth Treasury (Australia), *Reform of the Australian taxation system: Draft White Paper*, Australian Government Publishing Service, 1985.

4 With the indexation of the cost base where the asset had been held for more than 12 months. Prior to 11.45am on 21 September 1999, a system of averaging capital gains was available to some taxpayers.

asset subject to the CGT event for at least 12 months.[5] The former Howard Government introduced the 50% CGT discount on the recommendation of the 1999 *Ralph Review of Business Taxation* (the "Ralph Review").

The Ralph Review described the introduction of the CGT discount as being "designed to enliven and invigorate the Australian equities markets, to stimulate greater participation by individuals, and to achieve a better allocation of the nation's capital resources."[6] Nevertheless, there is no direct evidence that the CGT discount has enlivened the Australian equities market via increased participation by individuals.[7]

The Ralph Review, in recommending the enactment of the CGT discount to "enliven and invigorate" Australian equities markets, did not seek to defend the policy in relation to the known negative effects it would have on vertical and horizontal equity and on the overall tax system integrity.[8]

3 Taxing Capital Gains – the relevance of efficiency and equity

One of the main purposes of a CGT is to ensure the integrity of the overall tax system; CGT is essentially a "backstop to the income tax system".[9] The importance of this relates to the fact that it is "difficult to delineate the boundaries of the (capital gains) concept..."[10] Avi-Yonah and Zelik noted that "the main problems with [CGT] have been the difficulty of distinguishing between capital gains and ordinary income and taxpayers' attempts to convert ordinary income into capital gain",[11] and that taxpayers continue to use tax shelters to achieve such results notwithstanding the existence of tax provisions and judicial doctrines designed to prevent them.[12]

5 Div 115 ITAA97. Where a capital gain is calculated using the discount method, indexation does not apply. Certain CGT events are ineligible for the CGT discount. Taxpayers with assets acquired before 11.45am on 21 September 1999 may choose the indexation method rather than the discount method. However, where this choice is made there is only a partial inflation adjustment of cost base allowed, as it is only up to the September 1999 quarter.

6 Review of Business Taxation, *A tax system redesigned*, (Ralph Report No 4) Australian Government Publishing Service, 1999.

7 See: Brett Freudenberg and John Minas, 'Reforming Australia's 50 per cent capital gains tax discount incrementally' (2019) 16(1) *eJournal of Tax Research* 317.

8 Broadly, vertical equity is compromised since the distribution of capital gains is skewed towards higher-income taxpayers. The effect of this is that taxpayers at the highest marginal tax rate receive most of the benefit of the CGT discount. Horizontal equity is compromised as the tax treatment of taxpayers differs to the extent that their incomes include discount capital gains. Overall tax system integrity is compromised as taxpayers have an incentive to recharactise ordinary income as capital gains and, to the extent that they can do this, reduce overall tax liability.

9 Chris Evans, 'Taxing capital gains: One step forwards or two steps back?' (2002) 5(1) *Journal of Australian Taxation*, 114.

10 Rick Krever and Neil Brooks, *A Capital Gains Tax for New Zealand* (Victoria University Press for the Institute of Policy Studies, 1990) 1.

11 Reuven Avi-Yonah and Dmitry Zelik, 'Are We Trapped by Our Capital Gains?' (University of Michigan Public Law Research Paper No. 476, 2015) 40.

12 Avi-Yonah and Zelik, above n 11, 40. Executive remuneration in the form of shares or stock options may be considered a form of such a tax shelter. See eg David Ingles 'Tax equity: Reforming capital gains taxation in Australia' *The Australia Institute* pp 8-9.

The fact that capital gains are usually not realised annually is a cause of technical difficulties in taxing them in a way that is efficient, equitable and simple.[13] Moreover, the definition of a capital gain partly depends on whether the accrual model or realisation model is used. A capital gain under the accrual model is the increased value of an asset, irrespective of whether that asset is converted into cash or a cash equivalent.[14] A capital gain (or capital loss) under the realisation model is the increase (or decrease) resulting from the disposal of an asset or from any other realisation event.[15] For pragmatic administrative reasons, most revenue authorities tax capital gains on realisation.

A further consideration for policy makers is the appropriate tax rate at which to tax capital gains; this issue can be considered as one that has never been resolved. Since the debate about CGT preferences can be a politically charged one, it is imperative to distinguish between relevant empirical research and arguments that originate in the popular debate.

Commentary in favour of CGT rate preferences has argued that where rates are too high, the formation and mobility of capital are discouraged.[16] However, as noted in the Asprey Review, equity is also an important justification for a CGT, and the equity implications are an important consideration in deciding on a CGT rate.[17] The arguments about CGT rate preferences that relate to economic efficiency and equity are now considered in more detail.

3.1 Economic Efficiency Arguments

Some proponents of CGT rate preferences have held that CGT rate preferences can increase the level of national savings and that they may have a positive effect on economic growth.[18] It has also been argued that CGT preferences may increase tax system efficiency. This is based on the view that inefficiency may arise to the extent that taxpayers are "locked-in" to their investments because of a CGT.[19] A third argument advanced by some proponents of preferential CGT rates is that these are necessary to encourage risk and entrepreneurship.[20]

The claim that a CGT preference stimulates economic growth has been disputed given that, in order to be correct, the preference must increase domestic investment and such an increase is dependent on whether the preference is self-financing through increased realisations.[21] Burman has noted that concerns about the negative effects of CGT on saving and investment are overstated and that such concerns are better addressed through a lowering of the overall tax rate.[22]

Avi-Yonah and Zelik have described the argument that a lower CGT rate encourages savings as "empirically dubious",[23] and Gravelle has argued that reducing a budget deficit

13 Krever and Brooks, above n 10, 3.
14 Reuven Avi-Yonah, Nicola Sartori and Omri Marian, *Global Perspectives on Income Taxation law* (Oxford University Press, 2011).
15 Avi-Yonah, Sartori and Marian, above n 14.
16 See, eg, Bruce Bartlett, 'The case for ending the capital gains tax' (1985) 41(3) *Financial Analysts Journal* 23.
17 Taxation Review Committee, above n 2.
18 See eg, Shahira Knight, 'The Economic Effects of Capital Gains Taxation', U.S. Joint Economic Committee, June 1997.
19 John Minas, *The Implications of Capital Gains Tax Rate Preferences* (Oxford University Press, 2019).
20 Bartlett, above n 16.
21 Noel Cunningham and Deborah Schenk, 'The case for a capital gains tax preference' (1993) 48 *Tax Law Review* 319.
22 Leonard Burman, *The Labyrinth of Capital Gains Tax Policy* (Brookings Institution Press, 1999).
23 Avi-Yonah and Zelik, above n 11, 2