Taxing personal capital gains in Australia: An alternative way forward

Abstract

A comprehensive regime for taxing capital gains has been a feature of Australia’s personal taxation system for 30 years. The rationale for the inclusion of capital gains as a statutory extension to the income tax base is now well accepted, although there is somewhat less consensus about the extent to which gains should be included in the income base. Current policy dictates that capital gains are treated in a highly preferential manner, at considerable cost to the fisc and with significant implications for the equity, efficiency and simplicity of the tax system, a point noted in recent tax and financial system enquiries such as the Henry Review and the Murray Enquiry, as well as in the Tax Discussion Paper released by the federal government in March 2015.

This paper argues, on grounds of equity, efficiency and simplicity – and, importantly, on the grounds of fiscal sustainability – that the time is now right for consideration of the appropriateness of the existing preferences for individuals in the capital gains tax (CGT) regime. In particular, it queries whether the 50% CGT discount should continue to be available to individual taxpayers, and makes proposals for a reform that might lead to “improved” outcomes for the tax system and for Australia as a whole. In partial compensation for the removal of the 50% CGT discount, the paper considers the possible introduction of a CGT-free threshold (usually referred to as an annual exempt amount or AEA).

The paper supports its analysis by estimating potential first round (static) and (where possible) second round (dynamic) effects on tax revenue of such changes, concluding that the proposed changes would not only enhance the equity, efficiency and simplicity of the tax system going forward, but would also result in an overall revenue gain for the government.
1. Introduction

A comprehensive regime for taxing capital gains has been a feature of Australia’s taxation system for 30 years. The Draft White Paper which preceded the introduction of the Australian capital gains tax (CGT) in 1985 correctly identified that a tax system without a CGT violates 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 investment. Virtually all developed countries – New Zealand is the notable exception in the OECD – now have CGT regimes in place as a key part of their tax systems, as do most developing countries.

The justification for taxing capital gains lies principally in one of the two dominant modern economic theoretical approaches to taxation: the comprehensive income tax concept enshrined in the Schanz-Haig-Simons model, whereby personal income was defined as ‘the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.’ Hence increases in the value of assets, which is what a CGT regime effectively taxes, obviously fall within this comprehensive definition of income. But even proponents of the alternative optimal tax theory, which held in early and simple models that no capital income taxation was appropriate, now accept that it may be appropriate to tax capital income, albeit at lower rates than comprehensive income taxation proponents would argue.

*<credentials supplied>*

1 There was no general tax on capital gains in Australia before 1985, although the Income Tax Assessment Act (ITAA) 1936 did provide for limited taxation of capital gains in the period before then. This was through the former sec 26(a) of ITAA 1936 (later replaced with sec 25A of ITAA 1936 and now partly re-enacted as sec 15-15 of ITAA 1997), which included in assessable income the profit arising from the sale of property acquired by the taxpayer for the purposes of profit-making by sale or from the carrying on or carrying out of any profit-making undertaking or scheme; and the former sec 26AAA of ITAA 1936, which taxed short-term capital gains by including in assessable income the profit on the sale of property held for less than 12 months. Unfortunately, both sets of provisions had major shortcomings that meant that they were not entirely successful in achieving the objectives set for them.


3 See, for example, G Cooper and C Evans, The CGT Handbook, 6th Ed, Thomson Reuters, 2014, p. 11, which suggests that 167 out of 219 countries in 2014 had a CGT regime in place. This is not to suggest, however, that the case for the taxation of capital gains is readily accepted by all. As noted above, some countries, such as New Zealand, do not formally include capital gains in the personal income tax base; and some commentators continue to argue that it is inappropriate to tax capital gains: see, for example, the UK Budget submission by the Adam Smith Institute “ASIs Budget 2015 wish list: A tax code that actually makes sense”. Available at http://www.adamsmith.org/blog/economics/asis-budget-2015-wishlist-a-tax-code-that-actually-makes-sense/.


6 For a useful overview of the comprehensive income versus optimal tax theory arguments, and their impact upon capital gains taxation in six countries (Australia, Italy, the Netherlands, New Zealand, South Africa and the UK), see D White, Personal Capital Gains or Rate of Return Taxation? A Survey of Theory in Reform Proposals, Working Paper 05/2015, (Working Papers in Public Finance, Victoria University Wellington, April 2015).
The trend towards worldwide adoption is not to suggest, of course, that the introduction of a regime for taxing personal capital gains is not without its problems. In order to address concerns (largely unfounded) that a CGT might unjustly tax owners of assets on a retrospective basis; or (with more foundation) potentially might tax notional or inflationary gains rather than real gains; or (again with some justification) might disadvantage taxpayers by causing large gains to take them into higher marginal tax brackets as a result of the “bunching” of the gain in the year of disposal; or (perhaps) might “lock-in” owners to their existing assets, thereby distorting economic activity, a number of “preferences” or concessional treatments were built in to the Australian CGT regime on its introduction in 1985. Hence assets acquired before 20 September 1985 maintained their tax-free status (so-called grandfathering) even if disposed of after the introduction of CGT; the cost bases of assets were indexed in line with rises in the Consumer Price Index (CPI) such that any inflationary aspects of the gain were not taxed; a form of “averaging” was introduced to address the bunching problem and prevent taxpayers hitting higher marginal tax rates than would be the case if the gain had been spread over the years in which it had accrued; and a series of roll-overs and exemptions criss-crossed the CGT regime to prevent lock-in from having as significant or deleterious an impact than might otherwise have been the case and to make the introduction of the new tax as politically acceptable as possible.

Most of these preferences remained in place, subject to minor tinkering, through to 1999. In September of that year, and as a result of the prompting of the Review of Business Taxation, the indexation of the cost base and the averaging provisions were repealed in accordance with Recommendation 18.1, and a CGT discount, whereby 50% of the capital gain was excluded from the tax base for gains arising on the disposal of assets and related CGT events happening to individuals, was introduced in accordance with Recommendation 18.2. Somewhat surprisingly, the 50% CGT discount was introduced with little in the way of empirical evidence or modelling of the possible revenue effects, although some justification for its introduction may have been found in optimal tax theory.

This particular preference – the CGT discount – has continued from 1999 through to the present day, as have most of the preferences originally introduced in 1985. And in addition many new preferences have been introduced, as in the area of small business, where one relatively insignificant 20% exemption available in the early CGT years in relation to the disposal of goodwill has steadily morphed into the current tranche of four very generous concessions (three exemptions and a roll-over). These are available ostensibly to those “small” businesses with net asset values below a $6 million threshold or with annual

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7 Though note that the bunching argument has been strongly refuted in the literature on the basis that most capital gains are realised by taxpayers who are already in the highest tax bracket, and also because of the benefits of deferral resulting from a realisation basis CGT system. See, for example, N Cunningham and D Schenk (1992-93) 48 “The Case for a Capital Gains Preference”, Tax Law Review 319 at 328.

8 The literature describes a “preference” in relation to a capital gain as the beneficial treatment of that capital gain. See eg Cunningham and Schenk, above n 7, 319 at 320.


10 Ibid 595.

11 Although optimal tax theory is not specifically mentioned in the Review of Business Taxation.
turnovers below $2 million, but in fact are available to eliminate capital gains of a considerably higher magnitude for businesses that might be considered anything but small.  

Australia has therefore effectively experienced two different methods of taxing capital gains for personal taxpayers. From its introduction in September 1985 until September 1999, the CGT applied at ordinary income tax rates with indexation of the cost base of the asset. From September 1999 until the present time, the 50% CGT discount applies in instances where the asset subject to the capital gain has been held for at least 12 months. Under the discount method, although there is no indexation of the asset’s cost base, only 50% of the capital gain, net of capital losses, is included in the taxpayer’s taxable income.

The introduction of the 50% CGT discount did not constitute a complete replacement of the indexation method. Rather, taxpayers can choose between the discount and indexation methods, with the latter ‘frozen’ at the September 1999 quarter. This effectively means that the cost base of the asset cannot be adjusted for inflation beyond September 1999. In most (but not all) circumstances in the post-1999 era, an individual is likely to derive the greatest benefit from adopting the 50% CGT discount rather than indexation.

In the 2009 major review of Australia’s tax system, ‘The Henry Review’, a recommendation was made to reduce the CGT discount, from its current 50%, to 40%. The 2009 Henry Review also recommended the 40% discount rate for other forms of non-labour income such as dividends and interest. However, in 2010, the Federal Government at that time ruled out a reduction of the CGT discount. More recently, the 2014 Murray report into the financial system has considered (though stopped short of recommending) the removal of the CGT discount, and the federal government Tax Discussion Paper issued in March 2015 has posed the question for discussion: ‘to what extent is the rationale for the CGT discount, and the size of the discount, still appropriate?’

This paper argues, on grounds of equity, efficiency and simplicity – and, importantly, on the grounds of fiscal sustainability – that the time is now right for consideration of the appropriateness of the existing preferences for individuals in the CGT regime. In particular, it queries whether the 50% CGT discount should continue to be available to individual

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12 N Kewley, “The Old, the New and the Ugly: A Comparative Analysis of the UK, South African and Australian CGT Small Business Concessions – with Recommendations for Australia” (2013) 28(2) Australian Tax Forum 257, where the author notes, at 258, that “[i]n respect of capital gains taxation, the Australian small business is arguably the most privileged of its kind in the world. This sector has been favoured with the benevolent eye of government from the inception of CGT and the raft of small business concessions has broadened steadily ever since. Indeed, the reality of current relief is that only the unfortunate (or ill-advised) small business taxpayer incurs CGT”.

13 Review Panel, Australia’s Future Tax System: Report to the Treasurer – Part One: Overview (2009). This effectively would result in a higher rate of CGT given that 60%, rather than 50%, of net capital gains would be included in taxable income.

14 Ibid.

15 The Hon. Wayne Swan, MP, the then Treasurer, Joint Media Release with the Hon. Kevin Rudd, MP, the then Prime Minister, Stronger, Fairer, Simpler: a Tax Plan for Our Future, 2 May 2010. This was amongst a list of several policies, based on recommendations of the Henry Review that the then Government would not implement supposedly ‘in the interests of business and community certainty’.


taxpayers, and makes proposals for a reform that might lead to “improved” outcomes for the tax system and for Australia as a whole. In partial compensation for the removal of the 50% CGT discount, the paper proposes the introduction of a CGT-free threshold (usually referred to as an annual exempt amount or AEA) for individuals.

It is considered that this is a better alternative than a reversion to the indexation regime that operated from 1985 to 1999. The indexation regime ensured that taxpayers with capital gains were taxed on real rather than nominal capital gains by allowing the cost base of a capital gains asset to be indexed for inflation. The indexation regime was introduced at a time when inflation was relatively high compared to the current experience with relatively low rates of inflation – for example, according to the Australian Bureau of Statistics, the weighted average inflation rate increased by 7.6% between September 1984 and September 1985 and only by 1.7% between December 2013 and December 2014.

Furthermore, the indexation regime, of itself, does not offer a preferential treatment for capital gains. The AEA we propose in the paper can be considered a CGT preference, although, importantly, it is distinct from a CGT rate preference. The AEA would restore equity to the system as the preference is directed more to lower-income taxpayers with capital gains, rather than being heavily skewed towards higher-income taxpayers, as is the case with the CGT discount.

The AEA proposed in this paper would allow personal taxpayers to qualify for a complete exemption from any CGT liability by meeting one of the following two criteria:

1. the net capital gain for the income year is equal to or less than the AEA. In this paper, in Section 4, the fiscal implications for two possible AEAs, respectively $10,000 or $1,000, are estimated; and
2. the total capital proceeds from all relevant CGT events for the personal taxpayer in the income year are equal to or less than an amount which is twice the AEA.

The AEA 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 those taxpayers who meet one of the above criteria, but it will also allow taxpayers with net capital gains above the AEA threshold to be able to apply the AEA to reduce their taxable capital gain by the amount of the AEA. Note however that, like the tax-free threshold for income tax, the CGT AEA 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 is not available to be carried forward or backward to other fiscal years.

Under the reform package proposed in this paper, it is suggested that the operation of the capital loss and AEA provisions should be on a similar basis to the equivalent provisions in the United Kingdom (UK). In the first instance, the taxpayer would be required to apply all current year capital losses to their capital gains. If the resultant amount was less than the AEA, the taxpayer would have no capital gains tax liability. If, however, the amount was more than the AEA and the taxpayer had capital losses from previous years, they could apply
so much of these capital losses to their capital gains that would reduce them to the AEA threshold amount. If the capital losses from prior years did not reduce capital gains to the AEA threshold amount, the taxpayer would be liable for CGT on the remaining capital gain after applying current and prior year capital losses and the AEA.

In making the case for the removal of the discount and its replacement with an AEA, the paper refers to the experiences with preferences in broadly comparable CGT regimes, such as those currently in operation in the UK, Canada, South Africa and the United States of America (US). Interestingly, the original Australian 1985 CGT was in large part based upon the first two of these countries, whose CGT regimes were introduced in 1965 and 1972 respectively; the third (South Africa), with its CGT regime introduced in 2001, was based upon the UK, Canadian and Australian regimes, though arguably with significant improvements in design gleaned from careful analysis of the history of the operation of all three other regimes. The US taxed capital gains as ordinary income from the commencement of the federal income tax system in 1913; more recently, however, it has taxed capital gains at preferential rates.

In Section 2 the paper explores (and confirms) the usually stated rationale for the existence of a CGT regime in modern developed economies. This section also includes a consideration of the range of preferences currently employed in Australia and by the four broadly comparable common law jurisdictions in the design of CGT regimes that apply to individual taxpayers. Section 3 makes the case – on the grounds of equity, efficiency and simplicity – for the removal of the 50% CGT discount, accompanied by the introduction of a carefully targeted AEA. This section also considers some transitional and implementation issues, such as the need for certain integrity measures to protect the base from erosion as a result of strategic arbitrage or game playing activities (for example, “bed and breakfast” or ‘wash sale’ techniques) that may follow the introduction of an AEA. The fiscal implications of the proposed changes are contained in Section 4. Conclusions and recommendations are contained in Section 5.

Throughout the paper, the focus is upon the CGT discount as it applies to individuals/personal taxpayers rather than other forms of “entity”. The interaction of the personal CGT regime with that of trusts or corporate entities is generally beyond the scope of the paper. Moreover, whilst other preferences (such as grandfathering, or the small business concessions, or the main residence exemption) might be mentioned and may indeed be ripe for reform – as argued elsewhere — they are not considered in any detail in this paper.

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2. Taxing personal capital gains: rationale and preferences

The tax policy reasons for a CGT have been well documented in the literature. Specifically, a CGT improves horizontal and vertical equity, limits tax avoidance, broadens the tax base and reduces distortion of saving and investment.

Horizontal equity is the notion that taxpayers with an equal ability to pay should pay the same amount of tax. One of the primary arguments for a CGT referred to in the 1975 Report of the Taxation Review Committee (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. Although the Taxation Review Committee recognised that an accrued capital gain constituted an increase in the taxpayer’s ability to pay, justifying taxation of that gain, it referred to practical considerations as the reason that a CGT should only apply to realised gains. The Asprey Report’s conclusion on accrual taxation of capital gains being the ideal, although too impractical to implement, is very similar to the conclusion of the earlier Carter Commission Report from Canada. The Carter Commission had also recommended that, in a realisation CGT system, some deemed realisations were necessary so as to prevent permanent deferral of realised capital gains.

In contrast to horizontal equity arguments, vertical equity requires that taxpayers with a greater ability to pay should pay more tax. Differing notions of fairness among taxpayers mean that vertical equity is likely to be a more controversial issue than horizontal equity. Nonetheless, the notion of a progressive personal income tax system seems to have wide acceptance among OECD tax jurisdictions. According to the literature, the higher rate of tax payable for those with greater than average tax paying ability, as required by vertical equity, is determined in accordance with a notion of social consensus as to the appropriate degree of progression.

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21 The Asprey Report first recommended a CGT for Australia.
23 Ibid 415.
24 For events such as making a gift of an asset.
25 Recommendations of the Royal Commission of Taxation (CCH Canadian Limited, 1967, Canada), 83. The Carter Commission referred to the example of two specific events for which deemed realisation should apply – on making a gift of property or on giving up Canadian residency.
26 Burman, above n 20, p. 3.
The obvious reason that a tax system without a CGT — or indeed with a CGT at preferential rates — violates vertical equity is because high-income earners accrue the highest proportion of capital gains. For example, the most recently available Taxation Statistics\(^{29}\) indicate that resident taxpayers with a taxable income of over $180,000\(^{30}\), and a taxable capital gain, comprised approximately 3.6% of the total taxpayer population with a taxable capital gain, but realised over 56% of all taxable capital gains in 2012-13. It follows that a CGT system that fails to tax capital gains, or which taxes them at lower rates than ordinary income, is heavily skewed in favour of high-income taxpayers.

But the case for a CGT regime goes well beyond such arguments about the equity of the tax system. There are also strong efficiency reasons for taxing personal gains. Where capital gains are untaxed, there is an incentive for taxpayers to characterise income as capital gains as a way of reducing overall tax liability.\(^{31}\) In Australia, prior to the introduction of the CGT, tax planning to convert income receipts into capital gains occurred frequently and these opportunities for tax avoidance were an important policy concern.\(^{32}\) Moreover, inclusion of capital gains very obviously broadens the tax base and reduces the distortive behavioural effects that can arise by non-inclusion.

In short, the literature finds that the exclusion of capital gains from the income tax base constitutes a structural weakness in a tax system.\(^{33}\) The case for a CGT regime is virtually irrefutable. There is also a recognition, however, that the inability to tax capital gains as they accrue (as a result of the well-recognised valuation and liquidity problems that would arise under an accruals regime), with the inevitable consequence of having to accept (as has been the case in virtually all countries) a realisation basis, means that the regime has to accommodate a series of so-called preferences (such as lower CGT rates, or exclusions of parts of the gains, or exemption of certain amounts, as well as a variety of other concessional treatments) to ensure acceptance and smooth operation.

The taxation of capital gains at the prevailing marginal rates of tax for ordinary income is the tax policy ideal, at least for those who argue from the perspective of the comprehensive income concept.\(^{34}\) However, in practice, and for the reasons already identified, capital gains are often taxed at preferential rates or with part of the gain excluded from the tax base, or with other in-built tax preferences.

For example, in the US, capital gains are taxed at lower rates than the tax rates on ordinary income.\(^{35}\) And in the UK there are two rates of CGT – 18% and 28%.\(^{36}\) The 18% rate

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\(^{30}\) This calculation only includes taxpayers who had an overall tax liability, referred to as ‘taxable’ in *Taxation Statistics*.


\(^{32}\) WS Clark, above 19, at p. 31.


\(^{34}\) White, above n 6.

\(^{35}\) At the time of writing the maximum CGT rate in the US is 15%. However, there are some exceptions where specific types of capital gains can be taxed at a rate higher than 15%.
applies to those taxpayers whose income falls within the basic rate band for income tax.\textsuperscript{37} Notably, the 18\% CGT rate is only marginally lower than the 20\% ordinary income rate for taxpayers in this income tax rate band. The 28\% CGT rate applies to taxpayers in the two higher tax rate bands of 40 and 45\%.\textsuperscript{38} Hence those taxpayers subject to the 28\% CGT rate enjoy a significantly larger CGT rate preference than taxpayers in the basic rate band. This CGT preference is most pronounced for taxpayers in the highest tax rate band given that the tax rate on their capital gains of 28\% is significantly lower than the tax rate of 45\% on their other income.\textsuperscript{39}

Whereas some countries levy lower rates on personal capital gains, others choose to exclude part of the capital gain from the tax base (or conversely – though with the same effect – only include some capital gains in the taxable base), effectively lowering rates by other means. In Canada, for example, only half of the net capital gain is included in taxable income. In many respects this is similar to the Australian CGT regime, where the 50\% CGT discount (or exclusion) gives effect to the same type of preference as Canada’s 50\% inclusion. A notable difference between Canada and Australia’s CGT systems, however, is that in Canada the CGT preference applies without any minimum holding period for the asset, whereas in Australia the 50\% CGT discount only applies where the asset has been held for at least one year.

South Africa has a capital gains inclusion rate for personal taxpayers of 25\%, which is then taxed at the prevailing statutory marginal rates of income tax, varying between 0 and 40\%. Thus, the effective tax rate on personal capital gains in South Africa is between 0 and 10\%.

The case for preferential CGT rates is usually linked to providing an incentive for entrepreneurship and risk taking, increasing the level of saving, investment and productivity and counteracting the ‘lock-in effect’. However, as noted by Gravelle, arguments for preferential CGT encouraging risk are much more prevalent in the popular debate than in the economics literature.\textsuperscript{40} The economics literature is often critical of capital gains preferences as incentives for risk taking since they are untargeted and, as a result, provide incentives for non-risky CGT assets as well.\textsuperscript{41}

Another notable feature of some overseas CGT systems is the use of an AEA, whereby an initial amount of capital gains realised in a fiscal year is relieved from taxation completely. The UK has the most pronounced example of an AEA in operation, with (in the fiscal year

\textsuperscript{36} A third CGT rate of 10\% applies where the taxpayer is eligible for ‘Entrepreneurs’ Relief’. This 10\% rate applies specifically to capital gains, in respect of the material disposal of business assets, occurring on or after 23\textsuperscript{rd} June 2010, from three types of disposals: businesses; the assets of a business after it has ceased trading; and shares in a personal trading company. The Entrepreneurs’ Relief rate can be claimed on more than one occasion for qualifying gains up to a lifetime limit, which is currently £10 million.

\textsuperscript{37} £0 to £31,865 for the 2014-15 year.

\textsuperscript{38} For 2014-15, these are the ‘higher rate’ of 40\% on income in the range of £31,866 to £150,000 and the ‘additional rate’ of 45\% on income over £150,000.

\textsuperscript{39} These taxpayers pay capital gains at a rate which is approximately 62\% of their tax rate on ordinary income, whereas lower-income taxpayers in the basic rate band face a CGT rate which is 90\% of their tax rate on ordinary income.

\textsuperscript{40} J Gravelle, \textit{The Economic Effects of Taxing Capital Income}, 1\textsuperscript{st} ed, MIT Press, 1994, 68.

\textsuperscript{41} N Cunningham and D Schenk, above n 7, at 374.
ending on 5 April 2015) an AEA of £11,000 (approximately A$21,210 at May 2015 conversion rates). South Africa also has an annual exempt amount for capital gains, currently standing at R30,000 (approximately A$3,168 at May 2015 conversion rates).

Table 1 outlines the availability of the key capital gains rate preferences, which are the focus of this paper, in each of Australia, Canada, South Africa, the UK and the US.

**Table 1: Key current CGT preferences for individual taxpayers in common law jurisdictions (May 2015)**

<table>
<thead>
<tr>
<th>Country</th>
<th>CGT rates</th>
<th>Preferences</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Charged at marginal tax rates</td>
<td>50% exclusion</td>
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<tr>
<td></td>
<td></td>
<td>AEA</td>
</tr>
<tr>
<td>Canada</td>
<td>Charged at marginal tax rates</td>
<td>50% inclusion</td>
</tr>
<tr>
<td>South Africa</td>
<td>Charged at marginal tax rates</td>
<td>25% inclusion</td>
</tr>
<tr>
<td>UK</td>
<td>Charged under a separate CGT schedule at preferential rates</td>
<td>No. A rate preference is offered under a separate schedule, not by way of an inclusion/exclusion</td>
</tr>
<tr>
<td></td>
<td></td>
<td>AEA</td>
</tr>
<tr>
<td>US</td>
<td>Charged at preferential rates</td>
<td>No</td>
</tr>
</tbody>
</table>

3. The case for reform

This paper proposes the removal of the 50% CGT discount in Australia and its replacement with a more targeted non-cumulative tax free threshold for capital gains in the form of an AEA. As will be shown below, the reform proposal is justified substantially on the grounds of improved simplicity, achieved by reducing the number of personal taxpayers having to deal with CGT. A strong case is also made, however, on both equity and efficiency grounds for the reform package.

The paper suggests that these changes (the removal of the discount and the introduction of an AEA for personal taxpayers) should take place as a single package, noting that there will be ‘winners and losers’ from the proposals but that taken together the two proposals should minimise political opposition and potential ‘noise’ from vested interests.

Evaluation of the proposals needs to be undertaken against well-established benchmark criteria. Although one of the main purposes of any tax system, or any of its component parts, is to raise revenue, it is difficult to justify any particular tax provision on its ability to raise revenue alone. Fairness, in the form of vertical and horizontal equity, must be considered as

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42 United Kingdom, *The Capital Gains (Annual Exempt Amount) Order 2013*.
43 A CGT annual exempt amount has been suggested in previous literature such as: Evans, above n 19, at 317.
well as the question of the most efficient way possible of raising the required revenue. In addition, the extent to which the system is more or less complex as a result of the manner of its operation needs to be taken into account. According to the literature, CGT is a difficult tax to justify against the tax policy criterion of simplicity in isolation. This point was specifically noted by the Asprey Report:

[CGT] is a tax which, in any administrable form, must be complex and difficult, and produce some anomalies and inequities of its own. There is no doubt whatever that any revenue it raises could be more cheaply and easily raised in other ways. By the criterion of simplicity it fails.

This does not mean to say that simplicity in the case of CGT should be overlooked altogether.

Hence, the case for the removal of the 50% CGT discount and its replacement with an AEA is argued in this section using the three traditional criteria of equity, efficiency and simplicity as benchmarks for analysis. In Section 4 the implications for fiscal adequacy/sustainability of the reform package are explored.

**Equity**

As noted by Evans, shortly after the 1999 changes to the Australian CGT regime that saw the introduction of the 50% CGT discount, the essential reason for introducing regimes for taxing capital gains is one of equity, and the introduction of the discount in 1999 “savagely offends both the horizontal and the vertical aspects of equity”. For example, a share market or property investor with a gain of A$1 million made over a 5 year period would lose less than of a quarter of the proceeds in tax as a result of the discount; in comparison an employee earning A$1 million over that same five year period (ie earning A$200,000 per annum) would lose nearly half in tax. This outcome, a direct result of the CGT discount regime, does not sit well with the principle of horizontal equity.

The current 50% CGT discount is also inequitable from a vertical equity perspective as it is essentially a rate preference where the most significant benefit is targeted at high-income taxpayers. This is counter to a progressive tax system, designed with the principles of vertical equity and ability to pay in mind. A CGT regime where capital gains are taxed at ordinary income rates is more equitable than one which includes a rate preference for capital gains. The existence of CGT preferences such as the discount can result in marginal tax rates which are merely theoretical, especially at higher levels of income. As the proportion of discount capital gains included in assessable income increases, the effective marginal tax rate the taxpayer faces decreases. This can be considered an anomalous outcome in a tax system which purports to be progressive. In short, the magnitude of the 50% CGT discount for

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44 N Cunningham and D Schenk, above n 7, at 353.
45 Evans, above n 19, at 298.
46 Taxation Review Committee, above n 22, at p. 414.
personal taxpayers in Australia violates ability-to-pay principles, which are a fundamental feature of a progressive tax system.

There are, on the other hand, strong equity grounds for the introduction of an AEA. In terms of horizontal equity, it remains a fixed amount regardless of the size of the gain, and therefore does not have the capacity to produce the anomalous horizontal equity outcomes that can emerge from the discount. It also mirrors (whether accurately or otherwise) the tax-free threshold on the income side, and therefore provides even more horizontal equity between different forms of personal income.

Moreover, the AEA is a superior policy measure to the CGT discount on vertical equity grounds as it provides less of a tax preference to higher-income taxpayers than the CGT discount. An AEA of A$10,000 will save taxpayers on the highest marginal rate a maximum of A$4,500, in contrast to the open-ended maximum available under the current regime. The larger the capital gain, the less effect the AEA will have on reducing tax liability. This is consistent with the basic premise of a progressive tax system.

**Efficiency**

Efficiency in relation to tax system design is usually taken to refer to economic efficiency. Broadly, a tax system is seen as economically efficient to the extent that it does not, of itself, alter taxpayer behaviour. Removing the 50% CGT discount achieves increased efficiency because the deadweight costs associated with tax planning aimed at characterising income as capital gains are removed from the tax system. It is well recognised in the literature that a large difference between the tax rate on ordinary income and capital gains encourages taxpayers to devise schemes to re-characterise the former as the latter.48 The existence of the discount in Australia has considerably distorted economic behaviour in all sorts of ways. Clark, for example, notes that “[t]he concessionary treatment of capital gains income is arguably the primary motivation for financial investment in negatively geared real estate, which aims to shift all of the investment return into the capital gain on the eventual sale of the asset.”49

One of the efficiency benefits of an AEA is that for lower income taxpayers with small capital gains, there is more of an incentive to realise these gains in comparison with the current CGT regime. This is because in doing so there will be no capital gains liability. That is, whereas tax considerations may have a negative impact on efficiency for lower income taxpayers under the current system, the AEA would alleviate such considerations for these taxpayers.

Moreover, the introduction of an AEA should not have detrimental effects on efficiency at higher levels of income, since there is no evidence that removing the CGT discount and introducing an AEA would increase incidence of any ‘lock-in’ effects. Although taxpayers have discretion over the timing of their capital gains realisations, the evidence suggests that

48 Burman, above n 20, p. 82.
taxpayers choose to realise capital gains despite them being subject to taxation.\textsuperscript{50} The AEA may, in fact, reduce the incidence of lock-in for some taxpayers given that capital gains up to the amount of the AEA would escape CGT under the proposal.

\textbf{Simplicity}

A tax system that taxes capital gains and other forms of assessable income at the same marginal rates has obvious simplicity benefits. The current CGT regime for personal taxpayers manifestly fails to do this.

Moreover, the 50\% CGT discount, apparently simple in concept, can cause significant complications in practice. These can include the excruciating legislative complexities encountered in the interaction of the discount provisions of Div 115 of ITAA 1997 with rules relating to specific forms of entity, such as the trust provisions; the tortuous interaction with the small business concessions in Div 152; and the existence of a series of detailed integrity measures, including those designed to ensure that the discount is not available where a corporate entity is used to hold newly acquired assets, thereby potentially circumventing the 12-month holding period rules that are required before the discount can be used.

The removal of the discount for foreign residents in 2013 (with effect from May 2012) neatly illustrates some of the complexity of the application of the provisions in practice. Where a CGT event occurs after 8 May 2012, the discount percentage applying to a discount capital gain from that event will depend on four factors: whether the asset was held on, or was acquired after, 8 May 2012; if the asset was held on 8 May 2012, whether or not the individual was a resident on that date; whether a choice is made by an individual who was a non-resident on 8 May 2012 to use the market value approach to determine the part of the discount capital gain that accrued on and prior to that date; and the residency of the individual during so much of the period that the asset was held after 8 May 2012.\textsuperscript{51} The myriad possible interactions of these four factors cause significant complexity for taxpayers, advisers and administrators alike, and can lead to unanticipated and unintended outcomes not only from a planning perspective, but also in terms of compliance consequences.

There are, therefore, a number of ways in which the existence of the CGT discount adds complexity to the CGT regime. Moreover, CGT is itself already a relatively complex tax that imposes disproportionate compliance costs on personal taxpayers. Prior research has established that CGT compliance costs are significant in Australia: they are high in relation to the amount of tax payable; the amount of revenue collected; and the compliance costs of other taxes.\textsuperscript{52} Further, earlier research has established that the compliance costs of the CGT regime in Australia are a concern to practitioners and that there is a serious problem of under-

\textsuperscript{50} For example, between 1994-95 and 1998-99 the amount of net capital gains realised by individuals increased from $1.555 million to $6.607 million. Notably, in these years capital gains were subject to taxation at ordinary marginal rates as the CGT discount was not in operation until 1999-2000. See Taxation Statistics 2009-10, 2012.

\textsuperscript{51} Cooper and Evans, above, n 3, at p. 148. The convoluted examples explaining the operation of the discount for foreign residents on pages 149 to 151 attest to the complexities that are evident in the current discount regime.

\textsuperscript{52} Evans, above n 27, chapters 4 and 5.
billing for CGT work in Australia: almost one in two practitioners revealed that they could not recover the full costs of their professional work on CGT from clients, with the average amount of under-billing standing at 30%.\textsuperscript{53}

If one accepts that CGT is an inherently complex tax, and one which imposes significant compliance costs on personal taxpayers and cost recovery problems for practitioners, one of the most effective ways of achieving some measure of simplicity is to institute a provision that minimises the number of taxpayers who are liable for this tax. As referred to above, this has been achieved in tax jurisdictions such as the UK and South Africa through the use of an AEA.\textsuperscript{54}

The replacement of the 50\% CGT discount with an AEA in Australia would achieve increased simplicity through removing from the CGT net the majority of taxpayers who have a CGT liability under the current system. Using Taxation Statistics 2012-13, it is possible to estimate the number and proportion of taxpayers who would no longer face a CGT liability at the two proposed levels of an AEA threshold. At a A$10,000 threshold for the AEA, the number of taxpayers with a resultant net capital gain of zero\textsuperscript{55} is 274,940 which is approximately 71\% of the taxpayer population who had a taxable net capital gain in 2012-13. If the AEA were set at A$1,000, this would result in 167,750 additional taxpayers without a taxable net capital gain. This represents approximately 43\% of the individual taxpayer population with a taxable capital gain in 2012-13. The simplicity dividend of permitting up to 71\% of existing taxpayers to avoid the requirement of dealing with such a complicated part of the existing personal tax system is an enticing prospect.

The relative benefits of increased simplicity appear to far exceed the relatively small cost of forgone revenue, which is explored in Section 4 below. This is because although the largest dollar amounts of capital gains accrue at higher levels of income, there are, in fact, a higher number of taxpayers with taxable net capital gains of below A$10,000 than with taxable net capital gains of A$10,000 or more. The simplicity impact of the proposed AEA is that a sizeable majority of those taxpayers with a taxable net capital gain are removed from the ‘CGT net’ altogether.

If the AEA were introduced as a stand-alone policy, there would obviously be a revenue cost. However, together with the removal of the CGT discount, there would appear to be an overall improvement on the existing CGT provisions, including an increase in revenue collected by the government (explored in detail in Section 4). If part of the rationale of the CGT discount was to reduce the magnitude of the ‘lock-in effect’, an AEA would appear to be a more targeted and less costly method of achieving the same policy outcome. It would appear that

\textsuperscript{53} Ibid. By way of contrast, average under-billing by tax practitioners in the UK was less than 15\%.

\textsuperscript{54} One of the arguments against an annual exempt amount is that its simplicity benefits are illusory where the taxpayer is still required to calculate their capital gain, notwithstanding that this gain may be exempt. However, this issue can be dealt with by introducing two criteria under which a taxpayer is exempt, one of these being exemption on the basis of the amount of capital proceeds.

\textsuperscript{55} For some taxpayers, subtracting the AEA from their existing net capital gains would result in a negative amount (capital loss). However, it is proposed that the exemption, of itself, should not result in a capital loss. Rather, the taxpayer can use the AEA to reduce an amount of net capital gain to zero, but not to a negative amount.
an AEA might reduce CGT liability to a higher extent at lower levels of income. That is, given that capital gains accrue more at higher levels of income, high-income taxpayers who realise very large capital gains will be taxed at the their marginal tax rate on the entire gain less the annual exempt amount.\textsuperscript{56} For lower income taxpayers with smaller capital gains, however, the AEA would appear more likely to reduce their CGT liability to nil.

The introduction of an AEA would, of course, lead to the introduction of some new complexities (including the need for integrity measures), but these would appear to be of a much lesser magnitude in comparison to those associated with the 50\% CGT discount.

Clearly, taxpayers have discretion on the timing of their CGT realisations and as a result, they may time these to occur when their CGT liability will be lower. In a tax regime with an AEA, taxpayers may choose to realise an amount of capital gains up to the limit of the AEA each year and to the extent that they are successful in doing this, they may avoid any CGT liability. This may cause problems, but it is not so problematic as to recommend against the introduction of an AEA. Indeed, various ‘policing’ mechanisms, which would prevent significant abuse by way of such end of year ‘bed and breakfast’ or ‘wash sale’ techniques, already exist, both by reference to the nature of the assets that are subject to CGT and in the form of existing legislative provisions.

Although realising capital gains up to the AEA can be relatively easily achieved with some types of capital gains assets such as shares (albeit with transaction costs in the form of duties and brokerage fees), it cannot for other types of capital gains assets such as real estate, where the size of the capital gain is significantly larger than the proposed AEA levels. Furthermore, as in the current CGT regime, where taxpayers choose to realise capital gains despite the gains being subject to CGT, under the proposed AEA, there is no evidence to suggest that taxpayers who realise large capital gains will not continue to do so. For some of these taxpayers, the CGT liability they face will increase due to the removal of the CGT discount. However, the decision to realise capital gains is not solely dependent on tax considerations. Given that the cost of the AEA is a fraction of that of the CGT discount, the proposed reform is more fiscally sustainable in comparison to the current CGT regime.

A second form of ‘policing’ exists by virtue of extant legislative provisions. For example, the Australian general anti-avoidance provision – Part IVA of the \textit{Income Tax Assessment Act} 1936 – may serve to nullify any tax advantage sought be way of end of year transactions. The Australian Taxation Office (ATO) has already indicated that they consider this provision would apply to a wash sale involving the crystallisation of losses on poorly performing assets in order to use the losses against capital gains derived on other assets.\textsuperscript{57} It is entirely conceivable that they might take the same attitude – and seek to apply the general anti-avoidance provision – against bed and breakfast techniques whereby assets were sold at the end of one tax year in order to crystallise a capital gain up to the amount of the AEA, and immediately re-acquired at the beginning of the next tax year with an uplifted cost base. The

\textsuperscript{56} Notwithstanding that some high-income taxpayers will have a CGT liability of zero as a result of the AEA.

\textsuperscript{57} TR 2008/1.
circumstances certainly appear to provide the prerequisite components of ‘scheme’, ‘benefit’ and ‘purpose’ required to enliven the general anti-avoidance provision.

To the extent that these policing measures (found in the nature of the asset or in existing Australian tax anti-avoidance provisions) might be found to be inadequate over time, it would be perfectly feasible to introduce the sort of integrity measures designed to counter such avoidance techniques with specific anti-avoidance measures along the simple lines used in the UK over recent years.

In summary, it has been argued in this section that the removal of the 50% CGT discount and the introduction of an AEA would constitute an improvement to the Australian personal CGT regime on the basis of the generally accepted tax policy criteria of equity, efficiency and simplicity, and that the introduction of the AEA does not pose any significant threats to the tax base. The next section of the paper considers the fiscal implications of the potential reform.

4. Estimating the tax revenue impact of the reform

This section is concerned with the fiscal effects of the proposed reform package. These tax revenue implications derive from four sources:

1. there is a ‘first round’ or static revenue effect in the form of an annual revenue benefit for the government that will derive from the removal of the 50% CGT discount. Effectively this measures the tax revenue currently foregone on an annual basis by the government as a result of excluding 50% of eligible capital gains from taxation;
2. there is a ‘second round’ or dynamic revenue effect in the form of a revenue cost or benefit to the government as a result of behavioural responses by taxpayers to the change in the rate of taxation of capital gains if the 50% CGT discount were removed, effectively constituting a doubling of the CGT rate;
3. there is a ‘first round’ or static revenue effect in the form of an annual revenue cost for the government that will derive from the introduction of an AEA. Effectively this measures the tax revenue that will be foregone on an annual basis by the government as a result of excluding a certain amount of capital gains (dependent upon the level at which the AEA operates); and
4. there is a ‘second round’ or dynamic revenue effect in the form of a revenue cost or benefit to the government as a result of behavioural responses by taxpayers to the introduction of an AEA.

Data are available from Taxation Statistics and other sources that allow the calculation of the revenue effects of the first three of these sources with some degree of reliability, albeit on a somewhat robust and historical basis, with a calculation undertaken for the 2012-13 fiscal year. Unfortunately it has not been possible to precisely calculate the dynamic effects of the introduction of an AEA, as it would require data on the marginal tax rates on capital gains for a sample of taxpayers in the population. More specifically, the fourth revenue effect requires calculations based upon individual rather than aggregate taxpayer data. Such data, required to calculate effective marginal tax rates, are not available from Taxation Statistics. More
importantly, Australia has not previously had an AEA applying to capital gains, meaning that any dynamic revenue effect estimate would not be based on actual observation of taxpayer responses to an AEA and would require a large number of assumptions. For this reason any estimates derived would likely prove unreliable. In contrast, the dynamic revenue effects of the abolition of CGT discount are based on Australia’s actual experience with a CGT rate change. Specifically, an elasticity point estimate derived from a previous empirical study where a CGT rate change was observed was applied to CGT revenue in the benchmark year of this study.

One possible behavioural response that the AEA may induce is an ‘unlocking’ of capital gains that would not have previously been realised in the current regime. However, it would be inaccurate to describe the revenue implication of this specific type of realisations as revenue-losing. Specifically, if a taxpayer who would otherwise not have realised any capital gains decides to realise an amount of capital gains up to the AEA threshold, the government will not have lost any CGT revenue in comparison to the latest benchmark year in this paper (2012-13).

Although we do not estimate the behavioural response to the AEA, this does not prevent a conclusion being reached upon the likely overall revenue effects of the reform package proposed in this paper.

The paper now considers the fiscal implication of each of the four elements identified above in more detail.

**Estimating the static revenue effect of removing the CGT discount**

The most recent *Tax Expenditures Statement* reports that the revenue forgone as a consequence of the CGT discount for individuals and trusts in 2012-13 was A$3.99 billion. Given that this figure includes the value of the 50% CGT discount available to trusts, the A$3.99 billion figure is clearly not all attributable to the individual taxpayers that are the subject of this paper. The figure relevant to individuals is therefore somewhat less than A$3.99 billion, although the absence of any methodological explanation in the *Tax Expenditures Statement* of how the figure is derived or how much relates to individuals and how much to trusts means that it is not possible to derive a more precise figure for individuals from this source.

However alternative sources can be used to estimate the revenue effects with more precision. *Taxation Statistics* reports information on selected items reported in tax returns and CGT schedules by taxpayers, including the amount of the CGT discount applied by taxpayers. In 2012-13, the total amount of the CGT discount applied by taxable individuals was A$9.82 billion.

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In estimating the revenue foregone from the CGT discount for individuals in 2012-13, it is necessary to apply an average tax rate on capital gains to the additional taxable capital gains that would have been taxable in the absence of the discount. Using data from Taxation Statistics, it is possible to calculate that the average tax rate on net capital gains in 2012-13 was approximately 33.5%. Using this ATO-estimated average tax rate on capital gains for taxable individuals, the static revenue cost from the operation of the CGT discount for individuals in 2012-13 is estimated to be A$3.29 billion. This estimate of just over A$3 billion appears to be possibly conservative but nonetheless plausible given the Tax Expenditure Statement upper-bound limit for individual and trusts of A$3.99 billion for 2012-13.

**Estimating the dynamic revenue effect of removing the CGT discount**

In addition to the revenue foregone by the government in 2012-13 as a result of the static effects identified above, it is also necessary to take into account the possible behavioural responses of taxpayers to what effectively is an increased rate of tax on capital gains in the event that the CGT discount was abolished (the dynamic revenue effects). These second round effects are notoriously difficult to predict and depend upon estimates of the capital gains realisation response to changes in the tax rate, otherwise known as elasticity.

There is recent evidence on the capital gains realisation response in Australia, using time series data. This 2015 study estimated the capital gains realisation response for individual taxpayers using aggregate taxpayer data from the Australian Taxation Office and data on non-tax factors thought to influence capital gains realisations from the Australian Bureau of Statistics. Based on this study our estimate of elasticity is -0.47 at a 20.4% tax rate (the mean of the average tax rates on capital gains for the years between 1988-89 and 2012-13). This rate of responsiveness appears to be entirely plausible, falling within the broad range of elasticities identified in comparable overseas studies, and is used in the analysis below designed to estimate the dynamic behavioural effect of removing the 50% CGT discount in Australia.

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59 Table 27 in the Capital Gains Tax section of Taxation Statistics reports total net capital gains for taxable individuals of A$9.327 billion, with tax payable on these capital gains of A$3.127 billion. This implies an ATO-calculated tax rate on net capital gains of 33.529%.

60 The rate is described as ATO-estimated as its calculation is dependent on the amounts of net capital gains and tax on these capital gains as reported in Taxation Statistics.

61 That is, 33.5% of A$9.82 billion.

62 This is, in part, because the revenue estimates depend on the estimates of realisation response. The uncertainty surrounding capital gains revenue estimates is compounded by the fact that taxpayers have discretion over the timing of their capital gains realisations: see Congress of the United States, Congressional Budget Office, *How Capital Gains Tax Rates Affect Revenues: The Historical Evidence*, (Washington, DC, 1988), p. xii.


64 The original study found an elasticity of -0.49 at a 20.8% tax rate; however this has been updated to include taxpayer data for 2012-13, which was not available at the time of the original study.

65 See, for example, J Gravelle, *Capital Gains Tax Options: Behavioral Responses and Revenues*, CRS Report for Congress, August 2010, p. 7, where a summary of post-1980s US studies show, at a 22% tax rate, that elasticities range from -0.22 to -0.79.
The change in revenue from the behavioural response to the abolition of the CGT discount is estimated by multiplying the elasticity estimate of -0.47 by the revenue from discount capital gains in 2012-13 (i.e. A$3.29 billion), and then multiplied by the change in the tax rate over the 2012-13 tax rate (i.e. one). The result is an estimated 47% decrease in revenue from discount capital gains from A$3.29 billion to A$1.74 billion. The revenue forecasting method is consistent with the log-linear equation specification that was used in estimating the elasticity of capital gains realisations.

Estimating the static revenue effect of introducing the annual exempt amount

The introduction of an AEA for all individual taxpayers will clearly impose an annual cost to the fisc. The revenue cost of an AEA set at A$10,000, based on Taxation Statistics for 2012-13, would be approximately A$578 million. This is calculated on the basis of the number of individual taxpayers with taxable capital gains of A$10,000 or more in 2012-13 (114,470) multiplied by the A$10,000 AEA, multiplied by the average tax rate on capital gains in that year (33.5%). For taxpayers with capital gains under the A$10,000, the amount of capital gains reported in Taxation Statistics is multiplied by the average tax rate and this is aggregated with the amount calculated in the previous step.

In the event that the annual exempt amount was set at A$1,000, the revenue cost, based on the same year, would be approximately A$93 million. This is calculated on the basis of the number of individuals with taxable gains of A$1,000 or more in 2012-13 (221,660) multiplied by the A$1,000 AEA, multiplied by the 33.5% average tax rate on capital gains in that year. For taxpayers with capital gains under the A$1,000, the amount of capital gains reported in Taxation Statistics is multiplied by the average tax rate and this is aggregated with the amount calculated in the previous step.

Table 2: Static revenue cost of introducing an AEA (2012-13)

<table>
<thead>
<tr>
<th>Impact of AEA</th>
<th>Annual Exempt Amount (A$)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>Revenue cost</td>
<td>(0.578)</td>
</tr>
<tr>
<td>Percentage of taxpayers removed from ‘CGT net’</td>
<td>71%</td>
</tr>
</tbody>
</table>

Estimates of the revenue cost and percentage of taxpayers removed from the CGT net were also conducted for 2010-11 and 2011-12. It was found that for a A$10,000 AEA, 70% of taxpayers were removed in 2010-11 and 68% in 2011-12, and the revenue cost in each of these years was A$637 million and A$496 million respectively. For a A$1,000 AEA, 37% of the change in the tax rate compares the current real tax rate with the real tax rate if the CGT discount were abolished. In this case the result is one (16.8% divided by 16.8%).

66 The change in the tax rate compares the current real tax rate with the real tax rate if the CGT discount were abolished. In this case the result is one (16.8% divided by 16.8%).

67 See Minas, Lim and Evans, above n 63.
taxpayers were removed in 2010-11 and 38% in 2011-12, and the revenue cost in each of these years was A$109 million and A$81 million respectively.

**Estimating the dynamic revenue effect of introducing the annual exempt amount**

As discussed earlier, our estimates of the revenue effects of introducing an AEA only capture the static effects of this particular policy change. That is, the estimates do not consider the behavioural effects of the AEA provision. For example, there is the possibility that the introduction of the AEA may encourage realisations of capital gains that taxpayers would have chosen not to make in the absence of the provision. Such a behavioural effect, to the extent that it might occur, would not be problematic from a simplicity perspective, since a taxpayer realising capital gains up to the AEA would not incur a CGT liability. Furthermore, one possible effect of the AEA might be for taxpayers to realise capital gains of an amount that is in excess of the AEA threshold, given that their overall CGT rate would be lower than in the absence of an AEA.

Nonetheless, it remains the case that data limitations constrain the ability to estimate the dynamic revenue effects of introducing an AEA. However it is unlikely that such revenue costs would exceed, in any circumstances, the net revenue benefits to the government derived from the other three elements discussed above. And when contrasted with the simplicity dividend that can be achieved as a result of being able to take up to 71% of existing personal taxpayers out of the CGT regime on an on-going basis, any such revenue cost of the AEA is likely to ‘pale into insignificance’.

**Net effects of the proposed reform package on government revenue and on simplicity**

In comparing these estimates of forgone revenue from the operation of an AEA with the revenue benefit of abolishing the 50% CGT discount (a static revenue saving of more than $3.29 billion in 2012-13), it is evident that removing the CGT discount and introducing an annual exempt amount (whether set at A$10,000 or A$1,000), a net revenue gain would occur. Whereas the CGT discount is an untargeted and expensive policy measure (from the perspective of the government), the revenue cost of the AEA is a fraction of that of the CGT discount. Even if the number of taxpayers who realised capital gains as a result of the AEA increased substantially, it would appear that the revenue cost would still be substantially less than that of the CGT discount.

Table 3 shows the net increase in revenue from static and behavioural responses. This conservative estimate, assuming a moderate behavioural response, is an overall revenue gain in 2012-13 of A$1.162 billion where the AEA is set at A$10,000 and an overall revenue gain of A$1.647 billion where the AEA is set at A$1,000. This confirms that replacing the CGT discount with an AEA results in an overall revenue gain.
Table 3: Summary of net revenue effects from the abolition of the CGT discount and the introduction of an annual exempt amount ($10,000 and $1,000): 2012-13

<table>
<thead>
<tr>
<th>Annual Exempt Amount (A$)</th>
<th>10,000</th>
<th>1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A$ billion</td>
<td></td>
</tr>
<tr>
<td><strong>Government revenue benefit of removing the CGT discount (static): (1)</strong></td>
<td>3.29</td>
<td>3.29</td>
</tr>
<tr>
<td><strong>Government revenue benefit of removing the CGT discount (dynamic): (2)</strong></td>
<td>1.74</td>
<td>1.74</td>
</tr>
<tr>
<td><strong>Government revenue cost of introducing an AEA (static): (3)</strong></td>
<td>(0.578)</td>
<td>(0.093)</td>
</tr>
<tr>
<td><strong>Net increase in government revenue (static): (1)-(3)</strong></td>
<td>2.712</td>
<td>3.197</td>
</tr>
<tr>
<td><strong>Net increase in government revenue (dynamic estimate of benefit of removing CGT discount, less the static estimate of cost of AEA introduction): (2)-(3)</strong></td>
<td>1.162</td>
<td>1.647</td>
</tr>
</tbody>
</table>

5. Conclusions and recommendations

Justice Richard Edmonds of the Federal Court has considered it surprising that the Henry Review of 2009 did not recommend the removal of the CGT discount: “Indeed, Henry did not even consider its merit by reference to the tax policy criteria it advocated the design of the tax system should be structured”. The judge considered it was important that the abolition of the existing CGT discount, just one of a number of ‘sacred cows’ he identified, be brought to the table for consideration and informed discussion.

The purpose of this paper is to bring this particular ‘sacred cow’ to the table and to propose a specific reform package comprising the removal of the CGT discount and the introduction of an AEA that, together, could enhance the equity, efficiency and above all the simplicity of the regime for taxing personal capital gains in Australia by removing up to 71% of existing personal taxpayers currently exposed to the ‘pain’ of the CGT regime from their compliance obligations without loss to the fisc.

It is estimated that the revenue package proposed would contribute between $1.16 billion and $1.65 billion to Treasury coffers, depending upon whether a $10,000 or $1,000 AEA were adopted and upon assumptions about possible behavioural responses. Clark has noted that

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‘over the thirty years since its inception, CGT has become a significant stream of Australian Government revenue’.\(^6^9\) Typically it comprises between 2% and 6% of total tax yield.\(^7^0\) The additional revenue generated by the proposed reform would provide some welcome relief to a government facing revenue deficits and financial constraints.

The authors of the paper accept that there are certain limitations to the analysis. In particular, the paper has not been able to furnish definitive estimates of the overall revenue impact of the reform package, partly because the estimates have been prepared using aggregate taxpayer data, whereas the dynamic response to the AEA requires data on the marginal tax rate on capital gains for a sample of taxpayers in the population. Specifically, in a tax system with an AEA, individual taxpayers will face a different marginal tax rate on capital gains in comparison to their tax rate on ordinary income. The aggregate taxpayer data in *Taxation Statistics* does not provide information on net capital gains and other assessable income at the individual taxpayer level. Nonetheless the authors are firmly of the opinion that the revenue outcome for the fisc will be at least revenue neutral and far more likely be positive, even when the behavioural responses to the introduction of the AEA are factored into the estimates.

There are also, arguably, some inefficiency issues associated with the AEA as it may constitute a feature of the tax system that influences taxpayer behaviour.\(^7^1\) However, the abolition of the CGT discount would, overall, appear to result in increased efficiency, given the distortions that exist in the current tax system as a result of it. And – as argued elsewhere in the paper – the equity arguments in favour of the reform are overwhelming.

Ultimately, however, the decision as to whether the CGT discount will be replaced by the introduction of an AEA will not depend upon arguments based upon equity, efficiency and simplicity; nor upon arguments related to the fiscal outcomes, though these will of course be important. Rather it will depend upon arguments based upon political ideology and upon the existence of a political champion prepared to drive through the change against vested sectional interests. Personal capital gains are ultimately enjoyed, disproportionately, by the wealthier sections of society. A reform that likely causes those sections to pay slightly more tax, even if it enhances the overall equity and efficiency of the system and reduces complexity for a majority of affected taxpayers, is unlikely to find such a champion in the current political climate.

\(^{6^9}\) J Clark, above n 49, p. 51.
\(^{7^0}\) G Cooper and C Evans, above n 3, at p. 18.
\(^{7^1}\) For example, some taxpayers may choose to realise capital gains up to the amount of the AEA threshold in each tax year in order to maximise the amount of capital gains that are not subject to tax. However, this type of planning is not available to all taxpayers with capital gains given that the amount of capital gains available for realisation for an individual asset may exceed the AEA threshold.