

Taxing personal capital gains in Australia: An alternative way forward

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Looking Forward at 100 years: Where Next for the
Income Tax?

CGT – background and context

- “Taxation of capital gains is one of the most difficult issues in tax theory and in tax practice” (IMF 1991)
- Nonetheless the case for taxing capital gains now reasonably well established
- Based upon comprehensive (Schanz-Haig-Simons) concept of income
- But even optimal tax theory accepts some capital income taxation may be appropriate on efficiency grounds
- Rationale underpinned by very strong equity arguments (vertical and horizontal)
- Though general acceptance that any CGT regime will not be easily or simply administered



CGT regimes have become ever more widespread

- First CGT in Norway 1911; followed by USA 1913
- Japan 1946; Denmark 1958; Sweden, Portugal, UK 1960s; Canada, France, Ireland, Spain in 1970s; Australia 1980s
- Second most widely introduced taxing regime in last 50 years (after VAT/GST)
- But NB still no CGT in Barbados, Egypt, Hong Kong, Malaysia, NZ, Netherlands (though NB TFRM)



Spread of CGT regimes (2014)

Region	Number of countries with a CGT system, or where CGs included in income	Number of countries with a business CGT system only	Number of countries without a CGT system, or where information is not available
Africa	41	4	9
Americas	33	4	12
Asia	29	11	9
Europe	35	3	10
Oceania	6	1	12
Total	144	23	52

Personal CGT – Design issues

- Even if widespread, no common principles in design of personal CGT regimes
- Hence no single consistent model around the world
- Theoretically design should be on accruals basis
- But liquidity and valuation problems dictate a realisation basis is usually adopted
- Which leads to problems of bunching, lock-in, inflation etc
- Which in turn give rise to multiple techniques designed to overcome the problems: lower rates; exclusions or discounts; averaging; cost base or other inflation adjustments; taper reliefs; annual exempt amount etc



CGT: coverage and yield

- Volatile revenue which typically accounts for between 2% and 6% of all tax receipts in Australia – but NB important integrity role and not insignificant in absolute terms
- Currently affects roughly 500,000 taxpayers (mainly individuals) – about 4% of all taxpayers (cf to UK: only 250,000 T/P's - roughly 1% of all T/Ps: role of AEA)
- CGs primarily made by wealthier T/Ps: 2011-12 only 4% of T/Ps earned > \$100,000 but accounted for > 57% of all CGs

Australian preferences

- Initially (1985-1999) taxed at marginal PIT rates with cost base adjustment and averaging
- 1999-date 50% CGT discount introduced for most gains where asset held > 12 months; net capital gain then taxed at marginal PIT rates
- Justification for change was not explicit (optimal tax theory/proxy for inflation and averaging?)
- there was minimal modelling of fiscal implications

Preferences in comparable regimes

Country		Preferences	
	Rates	Inclusion / Exclusion	Annual Exempt Amount
Australia	Charged at marginal tax rates	50% exclusion	No
Canada	Charged at marginal tax rates	50% inclusion	No
South Africa	Charged at marginal tax rates	25% inclusion	Yes: R30,000.
UK	Charged under a separate schedule at preferential rates	No	Yes: £11,000. Increased every year according to CPI.
USA	Charged under a separate schedule at preferential rates	No	No

Problems with the current regime

- It is grossly inequitable
- It is not efficient
- It adds unnecessary tax system complexity
- It deprives the fisc of badly needed revenue

An alternative way forward?

Proposal in paper is to

- remove the 50% CGT discount; and
- replace it with an annual exempt amount (AEA):
 - estimates based upon 2 possibilities: \$10k or \$1k
 - annual CGs up to AEA completely exempt and/or
 - annual CGs exempt where capital proceeds < twice amount of AEA
 - Annual CGs in excess of AEA reduced by AEA and then taxed at marginal PIT rates
 - AEA non-cumulative and given after set off of CY and PY capital losses



Arguments for the proposal

Equity

- Discount savagely offends horizontal and vertical equity
- AEA far more targeted, less violation of equity principles

Efficiency

- Discount considerably distorts behaviour
- AEA less distortive; reduces lock-in for T/Ps with smaller CGs and unlikely to increase lock-in for those with larger gains

Arguments for the proposal

Simplicity

- Discount currently adds considerable complexity to an already complex CGT regime. For example :
 - interaction with trust and other entity provisions
 - interaction with SBC in Div 152
 - integrity provisions
 - denial for foreign residents post May 2012
- AEA has capacity to remove up to 70% of individuals from the CGT net if \$10k AEA adopted, or up to 40% with only a \$1k AEA

Fiscal implications

Potentially 4 revenue impacts

- 1. Static revenue effect of removing discount**
- 2. Dynamic revenue effect of removing discount**
- 3. Static revenue effect of introducing AEA**
- 4. Dynamic revenue effect of introducing AEA**

Fiscal implications (1)

1. Static revenue effect of removing discount

- This will constitute a benefit/saving to the fisc
- 2014 *Tax Expenditure Statement* suggests the cost of the discount was \$4.7 billion in 2011-12
- This is upper bound as includes individuals **and** trusts
- *Taxation Statistics* shows total amount of discount given to taxable individuals in 2011-12 was \$9 billion
- Average tax rate on capital gains for individuals in that year was 33%
- Hence first round effect saving to fisc if discount removed is **\$3 billion**



Fiscal implications (2)

2. Dynamic revenue effect of removing discount

- This estimates the implications of the behavioural changes by individuals as a result of the change
- Second round effects are notoriously difficult to predict and depend upon CG realisation responsiveness to changes in tax rate (elasticity)
- Minas et al estimate elasticity of -0.49 at 22.5% tax rate in 2015 study (appears plausible in comparison to other studies)
- This results in an estimated 49 per cent decrease in revenue from discount capital gains from just under A\$3 billion to just over **A\$1.5 billion**

Fiscal implications (3)

3. Static revenue effect of introducing AEA

- This will constitute a cost to the fisc
- *Taxation Statistics* suggests that in 2011-12
 - the cost of a \$10k AEA would be **\$496 million** (ie 108,145 individuals with CGs >\$10k @ 33% plus taxable CGs of individuals with <10K CGs @33%)
 - The cost of a \$1k AEA would be **\$81 million** (ie 209,900 individuals with CGs >\$1k @ 33% plus taxable CGs of individuals with <1K CGs @33%)

Fiscal implications (4)

4. Dynamic revenue effect of introducing AEA

- Identifies the behavioural implications of the change
- Unfortunately not possible to precisely calculate the dynamic effects, as it 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*
- However 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

Fiscal implications (summary)

	Annual Exempt Amount	
	\$10,000	\$1,000
	\$ Billion	
Removal of discount (static)	2.95	2.95
Removal of discount (dynamic)	1.504	1.504
Introduction of AEA (static)	(0.496)	(0.081)
Net increase in revenue (static)	2.454	2.869
Net increase in revenue (dynamic)	1.008	1.423

Conclusions

- CGT discount under scrutiny from variety of perspectives:
 - Henry Review 2009
 - Murray Inquiry 2014
 - Justice Edmonds 2015
 - Tax Discussion Paper 2015
- Strong equity and simplicity grounds for its removal and its replacement with an AEA, and also good efficiency arguments for the reform
- Sound fiscal arguments for the reform
- But ultimately the chances of the reform happening will depend not on rational criteria or fiscal imperatives but upon political will and an appropriate political champion