# The case for restoring capital gains tax neutrality

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## Summary

Our capital gains tax system is letting us down. It is inefficient and inequitable. As many have noted, it is biassed in favour of short-term speculation, and generally privileges capital gains over other forms of investment income. Also, there are many distortionary exemptions, including owner-occupied housing and small business concessions.

Many have called for abolition of the 50 percent tax concession on capital gains – a change introduced in 1999 which was linked to the abolition of indexation of capital gains.

What such calls overlook is that the 1999 changes, in abolishing indexation, actually increased the capital gains tax burden on many investors, particularly for investments with modest real growth, and for investments held for a long time. Removal of the 50 percent concession, while reducing the rewards for short-term (often speculative) investment, would further disadvantage longer-term "patient" investment, thereby still giving a relative favour to short-term investment.

Also, if there is to be progress on widening the capital gains base to include owner-occupied housing and other presently exempt areas, indexation needs to be restored to assure investors that they will not be taxed on illusory profits resulting from inflation.

## Introduction – Capital Gains Taxation up to 1999

A return from an investment has two financial components. One is a dividend paid out of distributed profits; the other is a capital gain (sometimes a loss) as the enterprise grows (or declines) in value.

Typically, publicly-listed Australian companies pay out between 40 percent and 80 percent of their profits as dividends; the remainder is retained for re-investment. Provided those retained profits are invested wisely, the firm's market value rises and this is reflected in its share price. In a well-functioning market such re-investment is the source of capital gain. Startup companies may go for some years without paying any dividends, while older, established firms in stable markets may pay out most of their profits as dividends.

What holds for publicly-listed companies also holds for private investments, in a small business or residential real-estate. For real-estate net income is received as the rent received (less any maintenance and finance costs), and the capital gain is represented by the increase in the property's market value.

Ideally, income from investments should be taxed in the same way, whether that income arises from dividends or capital gain. In other words there should be tax neutrality between dividends and capital gain. To treat capital gains more favourably, for example, encourages firms to retain earnings, even though those funds may be put to better use if they are paid out to shareholders who can invest them in more productive enterprises.[1] In terms of equity, any distinction between the treatment of dividends and capital gains favours some investors at the expense of others.

Although neutrality is desirable on both efficiency and equity grounds, it can be difficult to achieve. While taxation of dividends can be straightforward under either a classical system (in which the shareholder receives no credit for company tax already paid) or an imputation system (the present Australian system, under which the shareholder's tax liability is offset by the amount of company tax already paid), there are three complications in taxing capital gains:

> First, there are valuation problems in determining one's year-to-year capital gains. In publicly-listed companies they can be calculated on the basis of listed share prices, but these are volatile. For private companies there is no ready measure of market value. Similarly, for some real-estate investments, market values may be difficult to assess with precision.
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> Second, although a capital gain may accrue to an investor, that does not mean the investor has the means to pay any tax liability, for an accrued gain in an asset's value does not carry any cash flow. In other words, the investor, through capital gains, may be "asset-rich but income-poor".
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> Third, some of the gain in an asset's monetary value is a result of inflation. That inflationary component is not a real benefit to the investor.

Although there are advocates of capital gains being paid on an annual accrual basis, the approach taken by most governments, including Australia's, is to levy capital gains tax at the time of realization of an asset, normally when an asset is sold for a cash consideration. Two important concessions in Australia include exemption of owner-occupied housing and the exemption of assets transferred to beneficiaries at death. Transfer of assets to at death is not deemed to be a realization (although a gift made before death would be).[2]

Relying on realization overcomes the first two complications, but it does not deal with the third complication, the taxation of illusory gains arising from inflation.

Until 1986 Australia had a very lax régime of capital gains taxation, in that all assets held for more than a year were exempt from capital gains tax (CGT). In 1975 the Taxation Review Committee established by the Commonwealth Government produced a report (The Asprey Report), recommending collection of CGT on investment assets at time of realization, but with indexation to remove the distortion of inflationary gains. That approaches the ideal of achieving neutrality between taxation of income and taxation of capital gains. The Commonwealth implemented this recommendation in 1986. Importantly, however, there was the decision to exclude gains on the family home, and to adopt an asymmetrical approach to capital gains and losses. (Indexation applied only to capital gains; losses were treated on a

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1. There are two arguments favouring a bias to retained earnings, in that the transaction costs of retention are lower, and in that the firm retaining its earnings is better-informed about risks and returns than the shareholders.

2. There are some small capital gains taxes on residual amounts in superannuation funds, accumulated from untaxed contributions.

nominal basis which did not compensate for inflation.) The basis for indexation was the Consumer Price Index, which is a generally-accepted measure of inflation.[3]

To illustrate the effect of inflation and indexation, consider an investor who bought 1000 BHP shares in early 1986, for a price of $5.00[4], and sold them in early 1999 for $17.00. The shareholder's nominal capital gain would have been $12.00 a share, or $12 000. But her gain, discounted by the CPI, would have been calculated by the method below, which brings the 1986 price up to a 1999 equivalent:

| | |
|---|---|
| CPI 1986-87 | 80.4 |
| CPI 1998-99 | 121.8 |
| Adjusted purchase price per share | = 5.00 x (121.8 ÷ 80.4) = $7.57 |
| Capital gain per share | = 17.00 – 7.57 = $9.43 |

She would have been liable for payment of CGT only on her real capital gain of $9 430, rather than her nominal capital gain of $12 000.

## The Ralph "Reforms" of 1999

In 1999, on the advice of the Ralph Review of Business Taxation, the Howard Government abolished indexation of CGT, but allowed a 50 percent discount on the nominal gains on sale of an asset.[5]

Using the above example, the same shareholder would have been taxed on one half of the nominal gain of $12.00, i.e. $6.00. To summarize the changes:

| | |
|---|---|
| Shareholder's nominal capital gain without indexation | $12 000 |
| Shareholder's capital gain indexed (régime from 1986 to 1999) | $9 430 |
| Shareholder's capital gain not indexed, discounted (régime since 1999) | $6 000 |

The 1999 changes were presented as a lowering in the impact of CGT, and the example above illustrates the point. There were two justifications for the changes. One was to reduce complexity, and the other was deliberately to favour lighter treatment of capital gains as a means of attracting investment.

The argument about reducing complexity does not hold up. There was a time when manual calculations of indexation would have been laborious and subject to error, particularly for shareholdings with numerous small capital transactions such as buybacks and dividend

3. Use of the CPI as a measure of inflation is not without its critics. The CPI measures only final consumer prices in capital cities, averaging across genders, ages and other demographic groups. For a discussion of the use of the CPI in Australia's CGT system, see Julie Smith "Tax Reform, the GST and Women" (The Australia Institute Background Paper #11, April 2008). Over the long term, however, most indicators of inflation converge.

4. The price on 2 January 1986, adjusted for subsequent splits. This, and other illustrative share price data, is taken from the Supertech "Share Price History" CD, with minor rounding adjustments for presentational simplicity. The Asprey CGT provisions took effect for assets purchased after 20 September 1985.

5. For superannuation funds the discount is effectively 33.3 percent.

reinvestment plans, but even in 1999 there were many desktop accounting packages capable of handling much more complex transactions. Indexation is a well-established practice, in both the public sector (e.g. pensions) and in the private sector (e.g. rents).

What is clear, however, is that from 1999 there has no longer been neutrality between dividends and capital gains.

The argument that privileging capital gains encourages investment is not clear-cut. There is a degree of international tax competition in relation to CGT, and there is the possibility that Australian policymakers feel constrained to keep up with this competition. But, as pointed out by many economists, corporate tax régimes are but one consideration in firms' investment decisions. Also, as shown further on in this paper, the 50 percent concession is of most benefit to investors in the short term (provided a year has passed) before inflation has any significant effect. The 1999 changes were structured so as to privilege short-term capital gains relative to long-term capital gains. Some may say this encourages "financial dynamism" (allowing funds to move quickly); others may suggest that such a skewed incentive encourages de-stabilizing speculation – another term for "financial dynamism".

One consequence of privileging short-term capital gains is that it can set off a positive feedback cycle of rising asset prices, fed by increasing investments in the expectation of higher capital gains – in other words a speculative bubble. The present financial crisis, which has seen the collapse of share and real-estate bubbles in most countries, can be attributed to many causes, but there is a strong possibility that permissive taxation treatment of capital gains will be found to be one of the causes.

The greatest distortion of the 1999 changes, however, is that they discriminate between different types of businesses and different types of investments.

The BHP example, used above, is the typical illustration of the effects of those changes. But BHP is a firm which has been undergoing a long period of growth. Consider a different example – an investor who bought 1000 Commonwealth Bank shares (a popular holding among small investors) in 2001 for a price of $28.00 and sold them in early 2009 for $35.00 – possibly because of liquidity needs in the financial crisis. Over that same period the CPI has risen from 130.3 to 165.8. Had indexation remained, the adjusted purchase price would have been $35.62 (= 28.00 x (165.8 ÷ 130.3)). There would have been *no* assessed capital gain under the indexation system. To summarize:

| | |
|---|---|
| Shareholder's nominal capital gain without indexation | $7 000 |
| Shareholder's capital gain indexed (régime from 1986 to 1999) | $ 0 |
| Shareholder's capital gain not indexed, discounted (régime since 1999) | $3 500 |

Contrary to popular perception, the 1999 changes did not universally lower CGT. They did so only for those assets which were enjoying growth at rates above inflation. For many transactions there has actually been an increase in assessed CGT.

In any economy there is a spectrum of corporate performance. Some firms experience strong growth, while others have little growth. Some firms are in growing markets while others are in mature industries with stable markets. Many people in small business deliberately constrain the size of their enterprises.

In such situations, where the capital value of a company remains stable in real terms, any system of CGT which fails to discount for inflationary effects will be taxing illusory (inflationary) capital gains.

In recognition of at least some of these distortions, following the 1999 changes several concessions were made to small businesses, resulting in some transactions, such as disposal of a business on retirement and rollover of a business, being exempt from CGT altogether. These are listed in David Ingles' recent assessment of Australia's CGT system.[6]

This means that all small businesses which meet the specified criteria are exempt from CGT, whether they have made a real capital gain or not. Under the previous indexation system, only those businesses without a real capital gain would have been exempt from CGT, while others would have been assessed on their real gain. In trying to compensate for the distortion resulting from non-indexation, the Government introduced another distortion, which treated all small businesses in the same way, whether they were growing or not, and completely ignored other classes of business.

## Reforming CGT – restoring indexation

Many people concerned with reforming CGT are calling for abolition of the 1999 changes. David Ingles, for example, calls for abolition of the 50 percent discount and of the small business exemptions.

This focus on the 50 percent discount is understandable. It has richly rewarded short-term speculation, particularly for assets held just over a year – which is far too short for any serious commitment. Under the previous arrangements any capital gain would have been discounted only by the rate of inflation – in the order of two to four percent – rather than by 50 percent.

But, as illustrated, the abolition of indexation is another significant distortion in the 1999 changes, which, for many low-growth assets, actually *increases* the amount of assessed capital gains.

For assets held for a long time, even modest inflation can have a dramatic effect on assessed capital gains when there is no indexation.

For a typical growth investment, rising in real value at 2.0 percent a year, Table 1 on the next page illustrates the effects of different CGT régimes under different inflationary scenarios for a 30 year investment. The three régimes are:

(1) The 1986 to 1999 system of indexation.

(2) The present system without indexation but with a 50 percent discount.

(3) A system without indexation and without the 50 percent discount.

6. David Ingles "Tax equity: Reforming capital gains taxation in Australia" The Australia Institute Technical Brief #1 2009 (www.tai.org.au). Also available on the TaxWatch website www.taxwatch.org.au.

**Table 1. Assessed capital gain on a $1000 asset with compound 2.0 percent real annual growth over 30 years**

| | Annual inflation | | | |
|---|---|---|---|---|
| | 0.0% | 1.5% | 3.0% | 4.5% |
| 1. With indexation | 812 | 1 268 | 1 969 | 3 039 |
| 2. Without indexation, with 50% discount | 406 | 916 | 1 698 | 2 892 |
| 3. Without indexation, without discount | 812 | 1 832 | 3 396 | 5 784 |

What stands out from this table is:

- if there is no inflation, the 50 percent discount method gives a large privilege to capital gains;
- if there is no inflation, removing the 50 percent discount restores the pre-1999 neutrality (because there is no inflation to index);
- if inflation is around three percent (the Reserve Bank target range until recently), the 1999 changes approximate the previous system for such long-term investments;
- if inflation is around three percent, removing the 50 percent discount nearly doubles the assessed capital gain.

This analysis may read like a defence of the 1999 changes, at least for long-term investments. But not all investments enjoy steady, real growth of two percent, and some do not grow at all. Table 2 illustrates the same effects for a capital-stable investment.

**Table 2. Assessed capital gain on a $1000 asset without real growth over 30 years**

| | Inflation | | | |
|---|---|---|---|---|
| | 0.0% | 1.5% | 3.0% | 4.5% |
| With indexation | 0 | 0 | 0 | 0 |
| Without indexation, with 50% discount | 0 | 282 | 714 | 1 373 |
| Without indexation, without discount | 0 | 564 | 1 428 | 2 746 |

In the absence of inflation, all three policies result in a zero assessment of capital gains for such capital-stable investments. But under quite modest inflation even the post 1999 changes result in a significant assessment of nominal capital gains, and the removal of the 50 percent discount doubles the distortion.

In sum, removal of the 50 percent discount would add another distortion into an already distorted system, except for the unlikely case that there will be no inflation in the future. It would be particularly onerous on assets with low real growth, for it simply doubles the distortion introduced in the 1999 changes. (For assets with negative real growth, such as perhaps a house in a country town, or a shareholding that has to be realized when the market is down, the effects are even more stark.)

The solution which stands out from this analysis is simply to restore the pre-1999 indexation method.[7]

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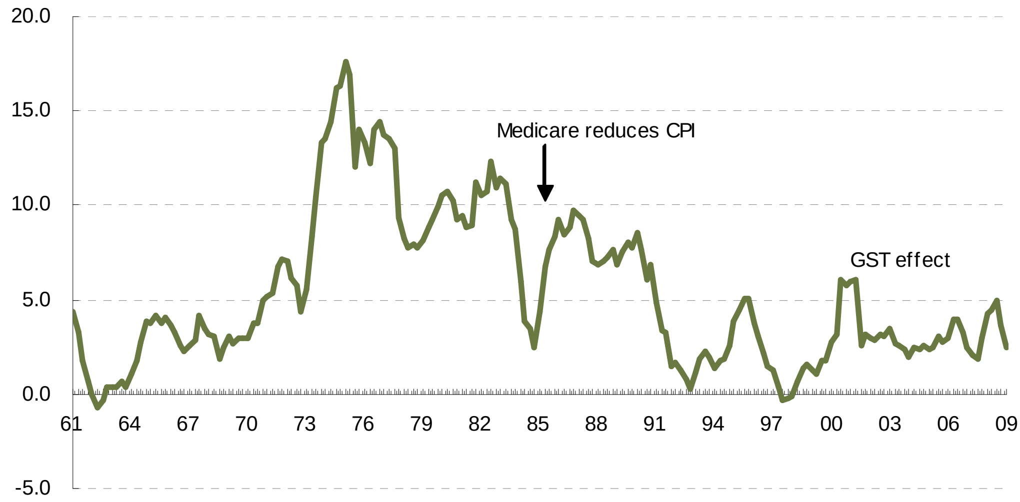
7. It may need some minor modifications, particularly in relation to real capital losses.

Some commentators, including Ingles, have correctly commented that in a low-inflation environment indexation is not particularly important. Technically this is correct, particularly if firms are enjoying strong real growth. But low inflation and high growth are both brave assumptions.

In the current phase of the economic cycle it is difficult to imagine the inflationary times of the 1970s and 1980s (see Figure 1). Over the last fifteen years we have come to expect monetary policy to keep inflation in the two to three percent range, but in reality such stability has been rare. Also, we have had it easy, enjoying the deflationary benefits of lowered tariffs, intense price competition from low-cost economies (particularly China), the benefits of new information technologies, and, more recently, a retreat of oil prices.

There is no guarantee, however, that these conditions will be sustained. In time China will revalue its currency, oil prices will rise, the gains from tariff reductions will have been exhausted, and we will be bearing increased costs resulting from our previous neglect of environmental degradation and from adjusting to climate change. Also, it is likely that as the world emerges from the current recession, many countries will sustain eased monetary policies to allow modest inflation to reduce the nominal burden of personal and government debt.[8] While we are likely to be spared the extreme inflation resulting from the mid-1970s shocks, the recent era of low inflation may be atypical.

**Figure 1. Consumer Price Index - Annual Percentage Change**




On growth and investment returns, we should also recognize that the period from 1980 up to 2008 has been atypical. High immigration, unsustainable exploitation of some natural resources and strong demand for coal and iron ore, have combined to give Australia a strong economic run over the last thirty years, aided by a boost of significant structural reform in the 1980s. Even once the present economic difficulties are behind us, Australia may be looking at a sustained period of more modest growth and therefore more modest investment returns – and therefore lower capital gains. Another contribution to lower capital

8. A possibility already reflected in rising long term bond yields.

gains may be a trend more conservative corporate financing, with less dependence on debt and more on equity.

Indeed, a CGT system that does not penalize long-term investment through taxing inflationary gains, and which does not penalize firms with modest but sustained growth, is ideal for such times.

Restoration of indexation would also make it easier for governments to apply CGT to presently exempt areas, including small business and owner-occupied residential property, and to deem a capital gain to have taken place at death. Without indexation any tax on owner-occupied residential property is likely to be highly distortionary and inequitable, and politically unacceptable as people realize that much of the capital gain on their homes is simply the result of inflation.

Over the long term nominal prices of residential property generally rise, but there is no guarantee on real prices. (A quick observation of trends in Japan, the Netherlands and now the USA confirms that residential property prices can fall.) In Australia one realistic scenario is that real prices in desirable inner-city and coastal locations will rise in real terms, while in far-flung suburbs and small country towns real prices will fall – but over a long period nominal prices will hold up or rise, depending on inflation. It is no coincidence that falling house prices are regionally correlated with low income and other indicators of disadvantage. There would be equity gains in applying CGT to owner-occupied residential housing on a realization basis, with indexation, and using some of the revenue from sales with real gains to compensate those who suffer real losses on sale.

A combination of deemed realization of capital gains on death and indexation would help overcome some of the “lock in” incentives presently applied to those who hold shares and similar securities for a long time. With an accumulating CGT liability resulting from inflation, there is a significant incentive for people to hold on to such securities until retirement, when their assessable income and therefore their marginal tax rate reduces. And the inevitability of a deemed realization of a CGT event on death would remove any relative penalty for disposing of a security during one’s lifetime.

Of course there is another distortion in our tax system resulting from a disregard of inflation. Our tax system allows borrowers full tax deductibility of the nominal interest on loans, and assesses lenders’ income on the full nominal interest received. This applies even though a part of interest paid or received is simply a compensation for the fact that loans, being denominated in nominal terms, lose their value over time. A neutral tax system would allow borrowers to claim tax deductibility only on the real component of interest paid, and would similarly assess lenders’ income only on the real component of interest received.

Such a reform, in making borrowing less attractive, would probably remove much of the incentive for borrowers to borrow heavily to invest in equities and housing. Many investors take advantage of the present tax deductibility on borrowing to structure their investments to make a significant tax loss – a phenomenon often referred to as “negative gearing”.[9] This practice has made real-estate investment particularly attractive for small investors: such investment is privileged because deductibility of the inflationary component of interest combined with an allowance for depreciation is effectively a double-counting of capital. Most commentators on housing reasonably consider that this phenomenon has driven up the price of rental accommodation.

9. An investment is truly “negatively geared” if the value of equity exceeds the value of debt. In common parlance in Australia “negative gearing” refers to investment situations in which the value of dividends or net rental exceeds the cost of interest paid to service the investment.

It can be argued that non-indexation of capital gains, combined with the removal of the 50 percent concession, would largely compensate for this distortion.[10] For heavily indebted investors, that is no doubt correct. But there are many investors who are not heavily indebted, and many who carry no debt at all. It would be inequitable to penalize all investors simply to neutralize the distortionary privileges enjoyed by a few. Rather than introducing a compensating distortion, it would be more logical to tackle the problem at its source, either by prohibiting "negative gearing", or, more basically, by disallowing as a tax deduction the inflationary component of interest payments.[11]

In short, the tax system needs reforming to remove the distortionary effects of inflation. The 1986 Asprey-based reforms, in providing for indexation of capital gains, went most of the way in doing this. Removal of the 50 percent discount which was introduced in 1999 would remove the distortionary incentives for short-term speculation, but there would be new and amplified distortions to the detriment of long-term investments and low -growth investments. It would be far better public policy to re-introduce indexation of capital gains, without any discount, and to attend to the other unfinished business of investment income tax reform, such as taxation of interest.

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10. This is essentially the argument put forward by David Ingles *op cit*.

11. If interest is taxed only in real terms there could be a first-round effect of a reduction in demand by borrowers and a compensating increase in supply by lenders, with a resulting lowering of interest rates (a supply curve shifted outwards, a demand curve shifted inwards). But interest rates are not set in such an isolated fashion; monetary policy and the influence of global markets should soon see a new equilibrium with less dependence on debt for such investments.