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Australia's 50% CGT Discount: Policy Oversight?

John Minas* and Brett Freudenberg**

Abstract

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

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1 Introduction

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

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

2 Background

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

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

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

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

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

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

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

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

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

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

3 Taxing Capital Gains – the relevance of efficiency and equity

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

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

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

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

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

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

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

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

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

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

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

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

3.1 Economic Efficiency Arguments

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

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

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

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

or increasing a budget surplus is a more certain way of increasing savings compared to reducing the CGT rate.[24] Although CGT rates have an effect on the rate of return after tax, the overall effect on the level of savings is low.[25]

In summary, there is a lack of empirical evidence to support a significantly positive effect of a CGT preference on savings and economic growth, and it would be difficult to justify a CGT rate preference principally on these grounds.

Tax System Efficiency

The economic efficiency of a tax or tax system relates to the degree to which the tax or tax system distorts the decisions that taxpayers would make in the absence of that tax.[26] Distortion occurs in a tax system with a preferential rate of CGT as this creates a preference for investments where most of the return is in the form of capital gains. Halperin argued that a CGT preference is only justifiable if one is of the view that the tax system improperly discriminates against certain investment types or that encouragement in particular types of investments is desirable.[27] It follows that favourable tax treatment should not extend to all items that meet the definition of a capital gain, as this may include items for which there is no case for special treatment.[28]

Another important negative effect of a CGT preference is the distortions that it can create in tax planning. In Australia, there is no system of quarantining the amount of the deduction for items such as interest expense. This means that a taxpayer can be in a net loss position in a given tax year and deduct the net deductible expenses, related to income producing capital gains assets, from their taxable income. An example of where such a practice occurs is for rental property assets, where the interest on loans and other deductible expenses exceed the rental income. Such investments can be tax effective because income losses reduce the taxpayer's assessable income from the first year that the taxpayer holds the asset, whilst the capital gain will be preferentially taxed in a future income year and only if the taxpayer decides to realise the capital gain. This is a tax planning opportunity which would not be as problematic if capital gains were taxed at the same rates as those applying to other income, or if the amount of losses which could be claimed as a deduction were subject to a loss limitation rule.[29] Negative gearing has been characterised as an aspect of tax law that converts "wage income into more concessionally taxed capital gains."[30] The United States of America, by contrast, has a rule in its tax code to limit the deduction of investment interest expense; essentially, the deduction is limited to the amount of investment income.[31] Given this significant tax policy difference, there is less of a case for

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24 Jane G. Gravelle, *The economic effects of taxing capital income* (MIT Press, 1994).

25 Gerald Auten, 'Capital Gains Taxation' in Joseph J. Cordes, Robert D. Ebel and Jane G. Gravelle (eds), *The encyclopedia of taxation & tax policy* (The Urban Institute Press, 2005) 181.

26 Minas, above n 19.

27 Daniel Halperin, 'Commentary: A capital gains preference is not EVEN a second-best solution' (1993) 48 *Tax Law Review* 381.

28 Halperin, above n 27.

29 To try to restrict the ability to immediately deduct 'revenue' losses generated by a CGT asset in Australia consideration might be given to whether a loss restriction rule should be introduced. To this extent some of the mechanisms adopted for members of tax transparent entities may provide some insight. For a discussion about potential loss restriction rules see: Brett Freudenberg, 'Losing my Losses: Are the loss restriction rules applying to Australia's tax transparent companies adequate?', (2008) 23(2) *Australian Tax Forum* 125.

30 John Daley, Danielle Wood and Hugh Parsonage, 'Hot property: Negative gearing and capital gains tax reform' (Grattan Institute, 2016) 17.

31 Internal Revenue Code §163 (d) (United States).

a CGT rate preference in Australia due to the absence of a limit on deductible expenses pertaining to CGT assets.[32]

Another argument advanced by proponents of CGT rate preferences is that the preferential treatment will counteract the lock-in effect. According to Auerbach, the lock-in effect is not a distortion to the overall composition of assets; rather, its effect is on the distribution of assets across investors.[33] Although the magnitude of the lock-in effect increases the longer appreciating capital gains assets are held,[34] the benefits of deferral also increase over time. Deferral benefits arise because capital gains are only subject to tax on realisation, rather than as they accrue. In an accrual CGT system, one of the specific advantages of deferral for taxpayers is that they can put the funds that would have been required to pay tax on capital gains each year to other uses. Taxpayers who borrow funds to buy assets that produce capital gains also have the advantage of claiming deductions in years that the expenses are incurred, while deferring tax liability on the capital gain until the asset is subject to a CGT event.[35]

Halperin argued that the costs of preferential CGT rates are more than any justification for it, and that lock-in is an overstated problem since, although it may deter individual asset holders from diversifying, it has an insubstantial effect on the economy-wide mix of investments.[36]

In conclusion, some of the economic efficiency arguments for a CGT rate preference are not entirely convincing. It is apparent that rate preferences for capital gains can introduce a new type of distortion into the tax system, as taxpayers may seek to invest more in assets where most of the return is in the form of capital gains than they would absent a preference.[37]

3.2 Risk and entrepreneurship

A weakness of the argument that CGT preferences are required as incentives for risk-taking is that such preferences are untargeted and they provide incentives for non-risky assets as well.[38] On this point it has been noted that only a small fraction of the lost revenue that occurs as a result of a capital gains preference is going towards improving incentives for entrepreneurship.[39] In the Australian context, the CGT discount is available for passive investment activities, and it is not limited to CGT assets used in business activities.[40]

A reduction in the CGT rate provides a windfall for existing assets at the time of the rate reduction.[41] Aside from the fact that this group of taxpayers will receive a higher after-tax

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32 The diminished case for a CGT discount in the Australian context also relates to the fact that Australia's dividend imputation system prevents double taxation.

33 Alan Auerbach, 'Capital gains taxation and reform' (1989) 42(3) *National Tax Journal* 391.

34 This is consistent with larger gains accruing over time together with a higher potential capital gains liability.

35 Provided the CGT asset is producing assessable income in terms of the nexus required for s 8-1 ITAA97.

36 Halperin, above n 27.

37 Minas, above n 19.

38 Cunningham and Schenk, above n 21.

39 Joel Slemrod and Jon Bakija, *Taxing ourselves: A citizen's guide to the debate over taxes* (MIT Press, 4th ed, 2008).

40 This can be compared to the small business CGT concessions in Division 152 ITAA97 are generally only available for 'active assets', being those used in the course of carrying on a business: section 152-40 ITAA97. Passive assets, such as those which are used principally to derive rental income are excluded: section 152-40(4)(e) ITAA97.

41 Minas, above n 19.

return if they decide to sell their assets, it is not clear how such a reform increases the overall level of investment.[42]

While some proponents of preferential CGT rates have argued that these can encourage and increase investment, this view overstates the importance of CGT rates to decisions to invest.[43] Also, while the effective CGT rate may be one of several considerations in decisions to retain or dispose of an asset, the realisation of a capital gain may not occur until several years after the purchase of an asset, if at all.

Overall, the economic efficiency arguments in favour of CGT rate preferences may not be as strong as is sometimes contended. Although there may be an expectation, originating in the popular debate, that CGT rate preferences can encourage investment in new ventures or riskier assets, they appear to be an ineffective means of doing so. Currently, the CGT rate preference is untargeted towards new investment, and the preferential tax treatment of capital gains is extended to the stock of existing accrued capital gains.[44]

3.3 Equity Arguments

A prominent argument against reducing CGT rates is the concentration of capital gains among higher-income taxpayers and the skewing of any CGT rate reduction towards this taxpayer demographic.[45] Preferential CGT rates are counter to the traditional tax policy criteria of vertical and horizontal equity.

Vertical equity is concerned with ensuring a fair tax burden is imposed on taxpayers with different levels of income and different taxable capacities. The principle of vertical equity is that those with a greater capacity to pay tax should shoulder a greater tax burden than those with a lesser tax capacity. The question of what constitutes a vertically equitable tax system can be influenced by individual notions of what constitutes a fair tax burden at different levels of income. The Australian personal income tax system is designed to meet the tax system design principle of vertical equity by way of a progressive tax rate scale.

CGT rate preferences are problematic from the perspective of vertical equity because taxpayers with high taxable incomes derive most of the benefits of the preferences since these taxpayers accrue and realise most capital gains. A CGT rate preference generally results in a vertically inequitable tax system since the benefits of the preference are concentrated at higher levels of income, given the skewed way in which capital gains are distributed.

The introduction of the 50% CGT discount in Australia in 1999 constituted a significant reduction of the prevailing CGT rate.[46] Although there were concerns at the time that the CGT averaging provisions were being used by some taxpayers too aggressively to take advantage of the tax-free threshold,[47] this, in itself, does not provide a sufficient tax policy justification for the CGT discount.

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42 Ibid.

43 Ibid.

44 Ibid. The lack of 'targeting' can be contrasted to the proposals for a larger discount to apply to investors in affordable housing: The Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures) Bill 2019.

45 See, eg, Gravelle, above n 24.

46 Although it is not a rate reduction by strict definition, it is one in effect, since where a capital gain is eligible for the discount only half of that gain, net of capital losses, is included in assessable income.

47 Australia. (1999). A Platform for Consultation, Discussion Paper 2, Building on a strong foundation (Ralph Report No 2), Canberra: AGPS, at p 308.

Notwithstanding Australia's progressive tax rate scales, vertical equity is compromised by the operation of the CGT discount.[48] Specifically, data on the distribution of net capital gains indicate that the CGT discount is more likely to be enjoyed by high income taxpayers, with nearly three-quarters of the benefit of the CGT discount going to the top 10% of taxpayers.[49] In 2014-15, the top 20% of taxpayers received 82% of the CGT discount benefit, whereas only 14% of the CGT discount was available to the bottom 70% of taxpayers: Figure 1.[50] In 2014–15 the 3.02% of taxpayers who were in the highest taxable income bracket[51] reported 61.28% of net capital gains.[52]

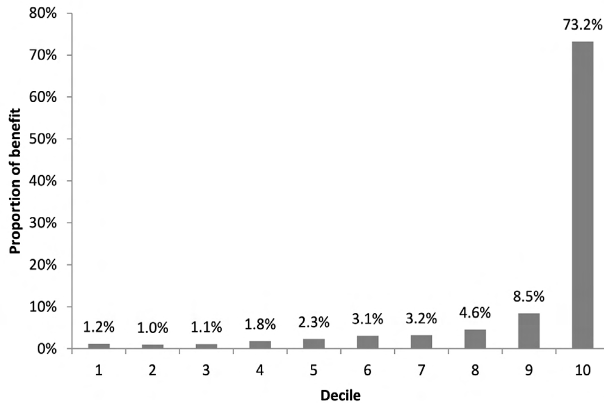

Figure 1: Distribution of CGT discount by household income

Source: Matt Grudnoff, 'Top Gears: How negative gearing and the capital gains tax discount benefit the top 10 per cent and drive up house prices' (The Australia Institute, 2015) 5.

Because of the skewed distribution of capital gains, a preferential CGT rate distorts the progressivity of the tax system. A personal taxpayer at the highest marginal tax rate can face a significantly lower effective tax rate in years in which they realise capital gains.[53]

Taxpayers who are at lower marginal income rates are less likely to own CGT assets, and they cannot reduce their effective tax rate to the same extent as higher income taxpayers by accessing the benefits of the CGT discount.

The other measure of the equity of a tax system is horizontal equity, which is concerned with taxpayers with the same income bearing the same tax burden. CGT rate preferences may

48 This is notwithstanding that the tax rate scales for personal taxpayers have been 'flattened' in recent years, which is a cause of reduced progressivity.

49 Matt Grudnoff, 'Top Gears: How negative gearing and the capital gains tax discount benefit the top 10 per cent and drive up house prices' (The Australia Institute, 2015).

50 Grudnoff, above n 49.

51 Australian Taxation Office, *Taxation statistics 2014-15,* Individuals detailed tables, Table 10, 2017.

52 Australian Taxation Office, above n 51, Individuals detailed tables, Table 10, 2017.

53 Minas, above n 19, 43. For example, rather than pay effectively 47% on realised capital gains, the 50% CGT discount means that for high income individuals the effective tax rate is closer to 23.5%.

lead to horizontal inequity since there is an unequal distribution of the tax burden amongst those taxpayers with the same taxable income, but who have differing proportions of capital gains to total taxable income. Although horizontal equity is a fundamental objective of tax policy, the way capital gains are taxed presents vexing problems that compromise the ability of the tax system to achieve horizontal equity.[54] The CGT discount breaches horizontal equity, given that taxpayers with discount capital gains — in most cases, higher-income taxpayers who are more likely to accrue and realise capital gains — face a lower effective tax rate than taxpayers who have non-capital income such as wages and interest.

Another equity argument against preferential rates of CGT relates to the benefits of deferral. The fact that these benefits are skewed towards taxpayers who have higher incomes and more capital gains is the reason that equity is of relevance. The deferral benefit relates to assets for which most or all of the return is in the form of capital gains. For these assets, deferral is seen as reducing the effective tax rate, since the money that would have been used to pay tax earns returns until the tax is paid.[55] Given their overall wealth, it could be the fact that high wealth taxpayers have greater capacity to hold assets for longer rather than needing to sell them to assist with liquidity needs. The deferral benefit compounds over the time that the asset is held, and this deferral is an argument for taxing capital gains at the same rate as ordinary income.[56] Moreover, even in the absence of a preferential rate for capital gains, deferral ensures that the treatment of capital gains is more favourable than the treatment of other returns to capital such as interest.[57]

Overall, the CGT discount does not perform well against the tax system criteria of vertical and horizontal equity. The negative vertical equity implications of the CGT discount mean that the effectiveness of the personal income system as a mechanism to redistribute income is compromised. This arises as most of the benefits of the CGT discount are enjoyed by high-income taxpayers. Horizontal inequity is another consequence of a CGT preference. Specifically, an increase in the amount of preferential capital gains that a taxpayer has in their assessable income results in a lower overall real tax rate compared to taxpayers whose assessable income does not include capital gains. The negative effects of a CGT preference on vertical and horizontal equity, and the deferral benefits of taxation of capital gains on a realisation basis diminish the case for a preference.

4 Public Commentary on the CGT Discount

4.1 Commentary from 1999 to 2005

One of the most strident opponents of the CGT discount in the 1999 Parliamentary debate on the policy was Mark Latham[58] who noted:

> These proposals before the parliament entrench the guiding light and symbol of taxation policy of the Howard government: the more you earn the bigger the tax cut. But they go even beyond the definition of a regressive tax because, under this government, the more you earn the bigger proportion of your earnings you receive in a tax cut….This goes beyond a regressive tax. These capital gains tax proposals are

54 U.S. Congressional Budget Office, *Perspectives on the ownership of capital assets and the realisation of capital gains* (Washington D.C. 1997).

55 Burman, above n 22.

56 Ibid.

57 Ibid.

58 At the time of the speech, Mark Latham was a backbencher in the Australian Labor Party (ALP) Opposition.

> unique: they establish a new category of gross tax inequity. This is a multibillion dollar free kick for the rich. It is an open invitation for the tax minimisers, the tax avoiders and the capital speculators to do their worst in the Australian economy.

Despite Latham's arguments against the CGT discount, the policy was enacted. It has been recognised that the treatment of capital gains is controversial and one of the most publicly debated issues in income tax; the fact that high-income earners accrue and realise most capital gains contributes to the divisiveness of the issue.[59]

In a 2002 article Chris Evans argued that "it is difficult to justify the introduction of the CGT discount…on any tax policy grounds".[60] Evans also noted that "cynically viewed, the changes are an exercise in good politics rather than good tax policy".[61] The "good politics" argument in relation to the enactment of the CGT discount identified by Evans is sound and it is further evidenced by the absence of a coherent policy justification for the discount in the years following its enactment. Similar arguments about the importance of good politics over good policy may also apply to the lack of attention given to reforming the discount, in nearly two decades since its enactment. It is notable that changing the rate of the 50% discount was not on the policy agenda of a major political party until quite recently.[62]

It was reported that in 2003 that, then Treasury spokesman, Mark Latham requested that Access Economics examine the implications of taxing capital gains at full marginal tax rates.[63] However, in 2004 while he was Leader of the Opposition, Latham ruled out changes to the CGT discount.[64] A 2004 article by journalist Allesandra Fabro included Mark Latham's quote that "[t]he generation of wealth in a certain part of the populace is not necessarily a bad thing", and described this statement as a "turnaround" on Latham's previous position on the CGT discount.[65] It would appear that Latham's decision, in 2004, to rule out changes to the CGT discount might have been the result of perceived political pressure in an election year to maintain the status quo, perhaps related to the fact that the then Coalition government was not proposing any changes to the CGT discount. Latham did not appear to outline any compelling case for the retention of the CGT discount at the time, nor did he detail his reasoning on why his thinking on the policy had changed.

A 2003 study by Chris Evans[66] included a survey in which some of the questions were about practitioners' opinions on CGT and compliance costs; some of the survey questions were about the CGT discount specifically. From these results it appears that there was an overall disagreement with the statement that the "freezing of indexation as at 30 September 1999 has reduced compliance cost for CGT" with 51% either disagreeing or strongly disagreeing with this statement.[67] There was a more neutral response to the statement that "The removal

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59 Slemrod and Bakija, above n 39.

60 Evans, above n 9.

61 Ibid.

62 The ALP Opposition went to the 2016 Federal Election with a policy of reducing the rate of the CGT discount to 25%. This is still part of the ALP policy platform at the time of writing. It has been argued recently that reducing the rate of the CGT discount would be "good politics", see Wood and Daley n 138 below, and Freudenberg and Minas, above n 7.

63 John Garnaut, 'Capital gains tax cuts go to highest earners' *Sydney Morning Herald*, 19 July 2004.

64 Peter Martin, 'The damage halving capital gains tax did', The *Sydney Morning Herald*, 21 April 2004.

65 Allesandra Fabro, 'Investment taxes to stay under Labor', The *Australian Financial Review*, 21 July 2004.

66 The survey respondents were 94 taxation advisors. The respondents were mostly accountants (80%), followed by lawyers (22%), and the remainder were both.: Chris Evans, 'Taxing Personal Capital Gains: Operating Cost Implications', (Australian Tax Research Foundation, 2003), at p 135.

67 Evans, above n 66, p 149. There was only 35% of participants either agreeing or strongly agreeing with the statement.

of the averaging has reduced compliance costs for CGT" with a fairly even split of 43% each of participants either agreeing or disagreeing with the statement.[68] Evans concluded that the introduction of the CGT discount did not increase CGT compliance costs, which in part was based on the fact the CGT discount being ranked last of the 18 factors that drive CGT compliance costs.[69]

In a 2004 article, Alan Kohler[70] described the decision to effectively halve the rate of tax on capital gains as "a huge mistake."[71] Kohler referred to the substantial effect on the property market caused by the interaction of the 50% CGT discount and negative gearing, but noted that "[e]ven on its own terms, cutting capital gains tax in half in September 1999 was an egregious mistake."[72] Kohler was critical of the Ralph Review's call for "[a] less harsh CGT regime which encourages taxpayers to invest in (shares)",[73] noting that the discount encouraged "what was already going on" and that following the end of the (stock market) boom in 2000, investment "swung totally towards property".[74]

It is Kohler's view that although, in theory, the CGT discount equally assists investment in shares and property, "real estate investors are better able to take advantage of it because of depreciation and capital works deductions."[75] Kohler's assessment is correct insofar as there is no depreciation or capital works deductions available for shares.

In a 2004 Letter to the Editor, Cameron Rider[76] referred to "Treasurer Costello's ill-fated decision in 1999 to introduce a (CGT) discount for property investors, while leaving negative gearing and building write-off concessions unchanged".[77] Rider's letter also referred to the fact that taxpayers could apply up to 100% of capital losses, while the CGT discount ensures that only 50% of the gain is subject to tax.[78] Rider argued that if the housing market cooled this would cause the losses to flow into the tax system and would have a negative effect on the budget position.[79]

4.2 Commentary from 2006 to 2013

In a January 2006 article, George Megalogenis[80] argued that the then Howard Government's decision to publicly rule out an increase in the CGT rate was due to "pragmatism, not policy principle." Megalogenis noted that the CGT discount was worth more to the "landlord class" than the Government could deliver through a cut in the individual tax rate.[81] Megalogenis added that "the capital gains tax (discount) could be the defining economic blunder of the Howard era."[82]

68 Ibid, p 149.
69 Ibid, p 163.
70 A financial journalist.
71 Alan Kohler, 'How tax system egged on property speculation', *Sydney Morning Herald*, 29 June 2004.
72 Kohler, above n 71.
73 Review of Business Taxation, above n 6.
74 Kohler, above n 71.
75 Ibid.
76 Then director of taxation studies at Melbourne University Law School.
77 Cameron Rider, Letter to the Editor, *The Age* (Melbourne), 29 September 2004.
78 Ibid.
79 Ibid.
80 Journalist and author.
81 George Megalogenis, 'Families shot by friendly fire', *The Australian* (Sydney), 7 January 2006.
82 Ibid

In a 2008 opinion piece, Maheswaran Sridaran[83] argued that "[t]he CGT discount should be abolished" and that this would "improve fairness" and "contribute to economic efficiency."[84]. A 2009 editorial in The Australian Financial Review described CGT concessions as a form of "largesse" and noted that the cost of such tax expenditures was "rising inexorably".[85] The editorial described CGT as a "bonus for the better-off" and argued taxpayers should be required to hold an asset for longer than only one year to qualify for the CGT discount and that "a more staggered system would be less expensive".[86] The editorial correctly predicted that "CGT revenue is likely to fall dramatically (in 2009)",[87] and argued that the government could encourage investment by aligning the CGT rate with a lower top marginal tax rate.[88]

In the 2009 Henry Tax Review it was argued that the CGT discount should be reduced to 40% but that it be broadened so that a discount of 40% applied to a variety of saving types to provide a more consistent treatment of savings.[89] This mooted 40% discount would apply to (i) capital gains; (ii) most interest income; (iii) net residential property income and (iv) certain interest expenses.[90] It was considered that widening the application of the discount, beyond capital gains, would result in a more consistent tax outcome and it would also provide a means of adjusting for inflation for the items it was to aply to.[91] The Henry Tax Review identified that by taxing the inflation component, an individual's consumption power is eroded.[92] This means for any given return the effective tax rate would increase as the inflationary component increases. However, the Henry Tax Review noted that for capital gains (as opposed to interest) the impact of inflation is less of an issue given that tax is deferred until realisation, and provides for a real increase in post-tax return the longer an asset is held.[93] With reference to OECD 2007 data the report concluded that while low-income individuals can respond to tax incentives with *more* savings, for high income individuals tax incentives result in a *diversion* of savings from taxable to tax preferred rather than *more savings* (emphasis added).[94] Such a conclusion can be contrasted to those made a decade earlier in the Ralph Report about the predicted impact of the CGT discount *increasing* investment by those higher rate taxpayers.[95]

The Henry Tax Review referred to how different tax treatment of financing can give rise to arbitrage opportunities. The Henry Review noted that whereas a rental property financed by equity produces a positive effective tax rate, the same investment, negatively geared, results in a more favourable tax treatment.[96] This is caused by asymmetries in the treatment of expenses and receipts for negatively geared property. This can be especially advantageous given that appreciated capital gains can be deferred until realisation. This

83 An academic at Macquarie University at the time.

84 Maheswaran Sridaran, 'Tax reforms for the best and fairest', The *Australian Financial Review* (Sydney), 10 January 2008.

85 Editorial, 'The gravy train derailment we have to have', *The Australian Financial Review* (Sydney), 2 May 2009.

86 Ibid.

87 Taxation statistics indicates that in 2007–08 net capital gains for individual taxpayers were approximately $24.3m and approximately $11.1m in 2008–09.

88 Editorial, above n 85.

89 Ken Henry, Australia's Future Tax System: Report to the Treasurer (The Henry Review), (Treasury, 2009), at p 62.

90 Ibid, p 62.

91 Ibid, p 64.

92 Ibid, p 65.

93 Ibid, p 65.

94 Ibid, p 68 citing OECD 2007, *Encouraging savings through tax-preferred accounts, tax policy studies* no. 15..

95 Compared to: Australia, above n 51, p 290-291. See earlier discussion about this.

96 Henry, above 89, p 68-69.

led the Henry Tax Review to conclude that this created significant distortions in how rental properties are financed.[97]

The Henry Tax Review considered a 40% discount a more realistic inflation adjustment than the 50% discount, given the Reserve Bank of Australia's inflation rate target of between 2% and 3%.[98] Overall, the Henry Tax Review was concerned about the bias that the 50% CGT discount creates compared to other saving methods by individuals.

The response of the then Rudd Federal Government to the Henry Tax Review to the broad discount recommendation was that the CGT discount would remain at 50%, and a "savings" discount of 50% would be extended to interest income of up to $1,000 per annum for a taxpayer. While initially the interest discount was to commence from 1 July 2011, it was deferred for 12 months, and then subsequently abandoned altogether due to budget constraints.

In a 2010 article, Geoff Winestock[99] noted that 'the refusal (by the Rudd Labor Government) to make any changes to capital gains tax or negative gearing rules effectively kills the proposal for a simplified "savings income" tax.'[100] Winestock's article noted that then Treasurer Wayne Swan "scotched the proposal" from the Henry Review to apply a uniform discount of 40% to all forms of savings income, and expenses and that this may have related to the notion that such a policy changes "would have created losers" by reducing the rate of the CGT discount.

4.3 Commentary from 2014 to 2017

Peter Martin[101] noted in a 2015 opinion piece that "the stock exchange lobbied hard" in favour of the CGT discount in 1999.[102] Martin disputes the claim in the Ralph Review's Report that the CGT discount would "encourage a greater level of investment, particularly in innovative, high-growth companies."[103] It is his view that the discount instead "delivered windfall gains to those who had already bought real estate and encouraged everyone else to dive in."[104] In his article, Martin calls for the abolition of the CGT discount and he notes that this would allow for a reduction in the overall tax rate.[105] This recommendation is consistent with the view that the CGT discount is not the best option to address concerns that high CGT rates may discourage saving and investment; the focus should instead be on broadening the tax base, eliminating preferences, and reducing top tax rates in general.[106]

In 2015, Tony Sheppard expressed the view that the 50% CGT discount was too generous. When speaking at the Committee for Economic Development of Australia conference, Mr

97 Ibid, p 70.
98 Ibid, p 72
99 Journalist at The Australian Financial Review.
100 Geoff Winestock, 'Henry Review Saving & Investing Deposits', *The Australian Financial Review* (Sydney), 3 May 2010.
101 Currently the economics editor for The Age.
102 Peter Martin, 'Easy tax reform: axe capital gains discounts', *The Sydney Morning Herald* (Sydney), 11 August 2015. Although not specifically referred to in Martin's article, the ASX made a submission to the Ralph Review in 1999 in which it argued in favour of the preferential treatment of capital gains.
103 Taxation Review Committee, above n 2.
104 Martin, above n 103.
105 Ibid.
106 Leonard Burman, 'Taxing Capital Gains in Australia' in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospec*t (Thomson Reuters, 2009) 127.

Sheppard said "I'm personally in favour of bringing the CGT rate up to the income tax rate. I can't see any reason to treat capital gains any different from income gains."[107]

In a recent call for the CGT discount to be abolished, Chris Cuffe rejected arguments that the CGT discount was needed as proxy for inflation, noting that:

> For much of the late 1980s, inflation was around 8%, and then in "the recession we had to have" in 1991, it fell significantly and then rose again. By 1999, it was approaching 6%. It is now closer to 2%. With inflation closer to 2%, and likely to stay low for many years, the 50% discount is extremely generous for assets realised after a relatively short period.[108]

The case for reducing the rate of the CGT discount has been made by business and professional organisations outside of the policy making process. The 2015 Re:think Tax Discussion Paper invited responses through a formal submission process and included the following question: "to what extent is the rationale for the CGT discount, and the size of the discount, still appropriate?"[109]

Although it is important for the CGT discount to be subject to scrutiny, the discussion paper question is worded in a way that implies that there was a time when the CGT discount was appropriate. It cannot be assumed, however, that all respondents shared this view.

Some submissions to the discussion paper supported the retention of the status quo. For example, the Australian Bankers Association supported the retention of the 50% CGT discount, but suggested there was a case for like treatment of other forms of savings such as bank deposits.[110] The National Australia Bank (NAB) submission outlined the organisation's support for the retention of the 50% discount because "any changes could negatively impact on Australia's attempts to improve productivity."[111] The NAB submission argues that the realisation basis of taxing capital gains leads to a lock-in effect, which, in turn, results in an allocation of capital that is less than efficient and reduced productivity.[112]

Other submissions called for a reduction to the rate of the CGT discount. Specifically, the KPMG submission recommended a reduction of the CGT discount to 25% and that the discount apply to interest income and unfranked dividend income, as well as capital gains.[113] The KPMG submission recommended that the 25% discount would also apply to capital losses and that there should no longer be a minimum holding period requirement for CGT assets.

The Westpac submission expressed the view that a 50% discount for assets held for as little as one year did not strike the right balance between removing the impacts of inflation and "discouraging speculative 'asset flipping' behaviour."[114] The Westpac submission recommended "an adjustment to the current arrangements for capital gains to align the tax

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107 Peter Martin, 'PM's audit chief Tony Shepherd says it's time to more properly tax super, capital gains', *The Sydney Morning Herald* (Sydney), 22 June 2015.

108 Joanna Mather, 'Chris Cuffe says CGT discount is no longer appropriate', *The Australian Financial Review* (Sydney), 9 March 2017.

109 Australia, The Treasury, 'Re:think: tax discussion paper: Better tax system, better Australia,' 2015, 193.

110 Australian Bankers Association, Response to Federal Government tax discussion paper, 2015.

111 National Australia Bank, Response to Federal Government tax discussion paper, 2015, 14.

112 Ibid, 13.

113 KPMG, Response to Federal Government tax discussion paper, 2015.

114 Westpac, 'Response to Federal Government tax discussion paper, 2015, 9.

treatment to other savings options."[115] It was explained in the submission that the goal of such a reform would be to ensure that: "investment decisions are not taken on the basis of after tax outcomes", so that it would "improve overall equity between investors at different marginal tax rates", and that it may "moderate the concentration of debt-funded risk-taking in property investment."[116] The Westpac submission recommended that grandfathering should apply to existing CGT assets in the event that the rate of the CGT discount was reduced.

The Business Council of Australia outlined the need for a review of the 50% CGT discount with the aim of achieving more neutral concessional treatment that consider other taxes and income distribution.[117]

Similarly, the Deloitte submission called for a review of the rate of the CGT discount and a consistent approach to the treatment of investment income and capital gains.[118] The Deloitte submission also recommended a phasing in period of several years for any future reduction to the rate of CGT discount.[119] In a report on the tax reform debate, Deloitte has noted that in the current system, the incentives to earn capital gains are too high for certain taxpayers (such as high-income individuals) and too low for other taxpayers, such as companies.[120] It is noted by Deloitte that the CGT discount is no longer meeting its policy objectives and that, given the cost to taxpayers and the economy, one option to consider is a reduction to the 50% CGT discount for individuals to 33%.[121]

A submission by the Taxation Law Committee of The Law Society of New South Wales Young Lawyers argued that "the current CGT discount is not appropriate" and that "the best policy would be to remove the CGT discount."[122]

The Financial Planning Association of Australia (FPA), in their submission to the discussion paper stated that it is "not convinced that the policy rationale for the CGT discount is still appropriate, given that advances in technology have made determining the change in value of an asset after CPI significantly easier."[123] The FPA questioned "whether there is a continuing policy reason for the CGT discount, beyond any public benefit gained from ensuring that there is an incentive for investments not to be 'churned' over period shorter than a year."[124] The FPA noted that even if this is the concern that the policy is intended to address, the size of the CGT discount should still be reconsidered.[125]

The EY submission in response to the *Re:think Tax Discussion Paper* expressed concern about "calls by some advocacy groups for (the CGT discount) to be abolished, to increase personal taxes to fund their preferred welfare expenditures."[126] The EY submission argued

115 Ibid, 9.
116 Ibid, 9.
117 Business Council of Australia, 'Response to Federal Government tax discussion paper', 2015.
118 Deloitte, 'Response to Federal Government tax discussion paper, 2015.
119 Ibid.
120 Deloitte, ***Deloitte busts key myths and recommends a circuit breaker for taxing superannuation, negative gearing and capital gains*** (26 October 2015) https://www2.deloitte.com/au/en/pages/media-releases/articles/mythbusting-tax-reform-second-report-261015.html.
121 Deloitte, above n 119.
122 The Law Society of New South Wales Young Lawyers, 'Response to Federal Government tax discussion paper', 2015.
123 The Financial Planning Association of Australia, 'Response to Federal Government tax discussion paper', 2015, p 13.
124 Ibid, p 13.
125 Ibid, p 13.
126 EY, 'Response to Federal Government tax discussion paper', 2015, p. 14

that the taxation of capital gains at full marginal rates "contributed to a reluctance of investors to sell CGT assets."[127]

The EY submission argues that "the rationale for the introduction of the CGT discount in 1999 is still valid today and derives from Ralph Review recommendations 18.2 and 18.3".[128] The EY submission appears to argue for maintaining the status quo on the taxation of capital gains and it states:

> The [Tax White Paper] process should involve transparent and truly independent research into the rationale for lower capital gains tax rates, to ensure that capital assets turn over and the proceeds are reinvested for the health of the economy, to avoid capital being 'blocked' or being exported from a country.[129]

The EY submission implies that a change to the current taxation treatment of capital gains could result in impediments to the turnover of assets, although it does not explain how it reached this conclusion. The EY submission's arguments in favour of retaining the CGT discount appear quite vague, as the following statement from the submission indicates: "[c]alls for abolition of the CGT discount do not properly analyse the factors in play here. We recommend that the TRWP process should see more comprehensive analysis of the issue, as the public will not be aware of the issues at hand."[130] This statement adds very little to the debate and it seems incorrect to assume that "the public" cannot understand the issues associated with the CGT discount. Moreover, calls for reform to the CGT discount have come from various sources including academia, business groups and professional organisations.

In response to a question about the impact of negative gearing on housing affordability, James Daniel, an economist from the International Monetary Fund, said that the CGT discount was of more relevance and that it was probably too generous, especially since it was introduced in an era of higher inflation.[131]

In early 2016, economist Shane Oliver noted that "the decision in the (late) 1990s to introduce the CGT discount reopened a huge hole in the tax system…which is therefore putting more pressure on regular income taxpayers to pay higher tax".[132] It was Oliver's view that the capital gains should be taxed as they were in the pre-21 September 1999 regime; that is, taxed at full marginal rates, with an inflation adjustment to cost base.[133]

In 2016, Innes Willox from the Australian Industry Group suggested that the CGT discount be reduced from 50% to 40% and that the accompanying Henry Review recommendations could be introduced.[134] Specifically that the 40% discount would apply to other forms of income from saving such as dividends and interest. This would also mean that 40% of related expenses would not be deductible. According to Willox, this "would make

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127 Ibid, p 14.

128 The submission states the recommendations were 'designed to enliven and invigorate the Australian equities markets, to stimulate greater participation by individuals, and to achieve a better allocation of the nation's capital resources.

129 EY, above n 127.

130 Ibid.

131 Adam Creighton, 'Reform or good times will be gone: IMF', *The Australian* (Sydney), 25 June 2015.

132 Kara Vickery, 'CGT discount under fire as Feds lose nearly $24b', *The Centralian Advocate* (Alice Springs), 8 January 2016.

133 Ibid.

134 Joanna Mather, 'Capital gains tax discount fair game,' *The Australian Financial Review* (Sydney), 11 February 2016.

substantial inroads into the disincentives against saving and investment inherent in our present tax system".[135]

According to Wood and Daley, reducing the capital gains tax discount "would be both good policy and good politics".[136] In their view, there is a case to offer a discount of lower magnitude than the current 50% discount, which they noted has "overcompensated many investors for inflation over the past 15 years".[137] Wood and Daley's argument that reducing the CGT discount would be good politics is in contrast to some of the other commentary that concludes that 'politics' is the factor that has prevented changes to the CGT discount.[138] It may be that there has been greater awareness of the CGT discount and its policy shortcomings in recent years.

A PWC report on the implications of implementing changes to housing tax benefits noted that "[r]emoving the CGT discount would…(be) expected to result in a more productive allocation of savings as distortions would be reduced and household investment choices would better represent individual circumstances and risk-preferences".[139]

In a 2016 article, Saul Eslake[140] stated that there was some merit in "the discount on capital gains for tax purposes (being) reduced from 50% to 40%...and (in) 'excess interest'…also (being) subject to the same discount for tax purposes".[141] Eslake's view was that this could prove effective in reducing the aspects of the taxation system that increase property prices, without the "political angst" that may accompany policies to reform negative gearing.[142] The same article quoted Chris Richardson,[143] who said that "the Turnbull government should seize the opportunity to reduce the CGT discount".[144]

Many proponents of taxing capital gains at full marginal rates would prefer a reduction in magnitude of the preference rather than maintaining the status quo in a scenario where these were the only two policy options. It follows that if policy makers had an ultimate objective of restoring CGT at full marginal rates, it does not necessarily follow that enacting a lower rate of CGT discount is an endorsement of the preference for personal capital gains. The reduction of the magnitude CGT discount would appear to be an overall tax policy improvement, even if one is of the view that taxation of capital gains at full marginal rates is a better option.

According to Fane and Richardson "the simplest way to repair the capital gains tax is to return to the pre-1999 arrangements".[145] Specifically, to tax capital gains at full marginal rates with the indexation of cost base. In recommending this reform, Fane and Richardson

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135 Ibid.

136 Danielle Wood and John Daley, 'Reducing the capital gains tax discount is an easy win. Why is the government ignoring it?' *The Guardian* (online), 26 April 2016.

137 Ibid.

138 Freudenberg and Minas, above n 7.

139 Paul Abbey, Jeremy Thorpe and Tom Seymour, 'Tax reform: informing the debate. What are the implications of changing housing tax benefits?', PWC, February 2016.

140 Independent economist and Vice Chancellor's Fellow at the University of Tasmania.

141 Joanna Mather, 'CGT discount of 50pc is real issue: experts.' *The Australian Financial Review* (Sydney), 17 February 2016.

142 Ibid.

143 Partner at Deloitte Access Economics.

144 Mather, above n 143.

145 George Fane and Martin Richardson, 'Federal election 2016: repair capital gains loophole instead.' *The Australian* (Sydney), 17 May 2016.

advised against changes to negative gearing, which in their view would introduce "new distortions".[146]

The prospect for reform of the CGT discount was heightened when in the lead-up to the 2016 federal election in Australia the Opposition Leader Bill Shorten announced a policy to reduce the 50% CGT discount to a 25% CGT discount, to take effect from July 2017, if the Labor Party were able to form government.[147]

In an article from March 2017, Michael Pascoe[148] argued that "Australia's CGT discount is obscene" and that "reducing the discount from half to, say a third or a quarter would have broader policy benefits while also playing a role in the investor/(first home buyer) power imbalance".[149] In a later article from May 2017, Pascoe called for the 50% CGT discount to be reduced to 40%.[150] He set out a number of arguments as to why this reduction to the discount would be good policy including that: "it was one of the well-considered Henry Review recommendations' and 'there is no rational explanation for why it is 50%, especially in a low inflation environment".[151]

Pascoe's concern about the lack of explanation for the decision to set the CGT discount for personal taxpayers at a rate of 50% is understandable. More fundamentally though, the policy reasons for a tax preference for personal capital gains in Australia have not been well articulated. On this point, it has been argued by Joseph Minarik that the burden of proof rests with those who advocate CGT rate preferences to demonstrate how they are appropriate.[152] It is difficult to argue that policy makers in Australia have proven the appropriateness of the CGT discount for personal taxpayers.[153] It is also the case that several of the submissions to the 2015 tax discussion paper were not convinced as to the appropriateness of the CGT discount.

4.4 Observations on CGT discount commentary

Some of the commentary analysed in this article implies that policy makers have not met the burden of proof requirement argued by Minarik.[154] That is, the appropriateness of the 50% CGT discount has not been confirmed or proven by those in favour of retaining the policy.

If the reduction of tax rates is a priority of policy makers, the tax policy principles of horizontal and vertical equity are better served by a reduction to statutory marginal tax rates, rather than to CGT rates.[155] It would also be the superior alternative from the

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146 Ibid.

147 This policy was announced as part of a tax reform package that included restricting negative gearing where the asset is a 'newly constructed home.' The Labor Party was not successful in forming government after the 2016 election. The Labor Party went to the 2019 Federal Election with the same policy to reduce the CGT discount from 50% to 25% and they were, again, unsuccessful in forming government.

148 Finance and economics commentator and ***BusinessDay*** contributing editor.

149 Michael Pascoe, 'Hitting investors proves law of unintended consequences' *The Age* (Melbourne), 23 March 2017.

150 Michael Pascoe, 'Forget the banks, check the $150 billion the ATO is not collecting locally' *Sydney Morning Herald* (Sydney), 18 May 2017.

151 Ibid.

152 Joseph J. Minarik, 'Capital gains taxation, growth, and fairness' (1992) 10 *Contemporary Policy Issues* 16.

153 Freudenberg and Minas, above n 7.

154 In addition, some of the commentary in favour of the CGT discount appears to have failed this burden of proof requirement.

155 Or the equivalent of a CGT rate reduction.

perspective of efficiency, since it would not encourage activity concerned with taxpayers and/or their advisors seeking to characterise income receipts as capital gains.

The CGT discount although originally promoted as a way of invigorating equities markets, appears to have had an, arguably, greater impact on investment in the housing market. Some of the commentary analysed has argued that it has resulted in an overinvestment in housing. It is the case that where features of the tax system distort investment decisions, inefficiencies result. Commentary from PWC, referred to in the article noted that an effect of the CGT discount is an inefficient allocation of savings. This appears at odds with the Ralph Review claim that the CGT discount would result in a better allocation of the nation's capital resources.

Commentary on the CGT discount appears to have increased following the Henry Review and the need for reforming the CGT discount has become more apparent in recent years. Much of the commentary analysed in this article is indicative of an appreciation of the negative tax policy implications of the CGT discount and a broad understanding of the need to improve the taxation of capital gains in Australia from a tax policy perspective. The 50% CGT discount has contributed to the compromise of tax system integrity and vertical and horizontal equity. Nevertheless, an improvement to tax policy in relation to the taxation of capital gains can be made by reducing the rate of the 50% CGT discount.[156]

5 Conclusion

The rate of the 50% CGT discount should be reconsidered in the reform of the taxation of capital gains in Australia. If the rate of the CGT discount were reduced, it would result in improvements to vertical equity, horizontal equity and efficiency.

It is of concern that the tax system has become a less effective instrument for redistributing income following the enactment of the 50% CGT discount. As some of the commentary in this article has identified, the CGT discount is effectively a tax rate cut for high-income, high-wealth taxpayers. Taxpayers who face the top marginal tax rate realise a higher proportion of capital gains than those in any other taxable income bracket.[157] Specifically, in 2014–15, the percentage of taxpayers who were in the highest taxable income bracket was 3.02%,[158] and this group realised 61.28% of net capital gains.[159] The inequality of the CGT discount is compounded by the fact that in a realisation based CGT system, which taxes capital gains at full marginal rates, there is a still a preference for capital gains through the benefits of deferral, which increase over the time that an asset is held.

It is apparent that there has been some reluctance from policy makers to abandon the CGT discount and revert to the pre-21 September 1999 CGT regime for taxing capital gains.[160] The tax policy rationale for the 50% CGT discount is unclear and policy makers have failed to set out a convincing rationale for its retention. It might be that as the scrutiny of and opposition to the CGT discount continues to increase, the case for reform will

156 Freudenberg and Minas, above n 7.

157 It is also the case that higher income taxpayers accrue a higher proportion of capital gains than those at lower income levels. Notwithstanding that there is a lack of direct information available on accrued capital gains, this can be imputed from other publicly available data.

158 Australian Taxation Office, above n 51, Individuals detailed tables, Table 10, 2017.

159 Ibid.

160 A prominent example of this reluctance was the Rudd Government's rejection of the Henry Review recommendation to change the CGT discount rate to 40%.

become inevitable. The political barriers to such a policy change appear to have decreased in recent years, as indicated by the commentary referred to in this article that calls for reform of the 50% CGT discount. While the debate about the appropriateness of the 50% discount continues, there appears to be a general interest in reforming the policy. In the absence of reforms to the 50% CGT discount, Australia risks having a tax system that lacks the "backstop" of a comprehensive CGT regime and the consequences of this include comprises to tax system neutrality, as well as the horizontal and vertical equity. In the 1970s, prior to the introduction of Australia's CGT provisions, it was recognised that an effective tax on capital gains was an important mechanism to improve equity in the tax system.