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The School of Taxation & Business Law (Atax) is part of the UNSW Business School at UNSW Sydney. We are the largest tax school in any university in Australia, bringing together a team of expert academic staff with backgrounds in law, commerce, tax, accounting and economics. At Atax, we're working towards building excellence in the tax profession, looking at tax from both a theoretical and practical perspective.

EDITORS' NOTE

The *eJournal of Tax Research* is a refereed journal that publishes original, scholarly works on all aspects of taxation. It aims to promote timely dissemination of research and public discussion of tax-related issues, from both theoretical and practical perspectives. It provides a channel for academics, researchers, practitioners, administrators, judges and policy makers to enhance their understanding and knowledge of taxation. The journal emphasises the interdisciplinary nature of taxation.

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Editorial

Prato Comparative CGT Conference 2017

This special issue is devoted to Professor Chris Evans (School of Taxation and Business Law (TABL), UNSW Sydney) who was instrumental in establishing the *eJournal* in 2003. It marks his formal retirement from UNSW Sydney, although he continues in academia with fractional appointments at UNSW Sydney and at the University of Pretoria.

Chris is an outstanding, all-round tax academic who has made, and continues to make, an enormous contribution to the discipline of taxation. As an academic leader, he was the Director of the rapidly growing Australian School of Taxation (Atax) at UNSW Sydney from 2001 to 2006. As a teacher, Chris has inspired generations of undergraduate and postgraduate tax students, mainly in Australia but also through his visiting positions at universities in Austria (Vienna University of Economics and Business), Canada (University of British Columbia), New Zealand (University of Canterbury) and the UK (University of Oxford). He is co-author of two core text books in Australia: *Australian Taxation Law*, now in its 29th edition, and *Australian CGT Handbook* (formerly *Cooper & Evans on CGT* and now in its 10th edition).

In terms of research, he is a prolific scholar who regularly publishes in quality tax journals around the world. While his research interests are diverse, his contributions to capital gains taxation and tax compliance costs are most widely acknowledged. He has successfully led Australian Research Council Linkage projects on personal income tax reform, tax complexity and Australia–China tax barriers, as well as conducting research for many other bodies, both national and international. In addition, he has successfully supervised many MPhil and PhD graduates in taxation. More recently, as an Extraordinary Professor at the University of Pretoria, Chris has been responsible for raising the profile of tax research in South Africa and in Africa at large. He was recently formally recognised as a “Leading International Scholar” by South Africa’s National Research Foundation.

Chris has been an influential tax expert through his engagement with the tax academia, tax profession and tax authorities around the world. A sample of such roles includes: Editor in Chief of the *Australian Tax Review* (an A-ranked journal) from 2014 to 2016; International Research Fellow, Centre for Business Taxation, University of Oxford; Visiting Fellow at the Tax Administration Research Centre at the University of Exeter; Inaugural Chair of the Asia–Pacific Branch of the UK’s Chartered Institute of Taxation; various positions with CPA Australia and Chartered Accountants Australia and New Zealand. He has acted as a consultant to the Australian Taxation Office, the Board of Taxation, the New Zealand Inland

Revenue, the World Bank and various overseas governments and government agencies. His awards are many, including: the UNSW Staff Development Award in 2004; the CPA Australia National President's Award in 2004; and the Australasian Tax Teachers Association (ATTA) Medal in 2007.

To celebrate the occasion of Chris' 65th birthday, an international conference was organised by three of his long-time colleagues, Professor Rick Krever, Dr Peter Mellor and Professor Binh Tran-Nam. Reflecting a major strand of Chris' research interests, the conference was titled Comparative Capital Gains Taxation (CGT) and held at the Prato campus of Monash University from 26 to 28 September 2017, with very kind support from the Accounting for Social Change Research Group, QUT Business School, Queensland University of Technology, TABL, the Law School, University of Western Australia and PwC. The conference brought together a group of Chris' colleagues and former students from Australia, Canada, Hungary, New Zealand, South Africa, the UK and the US to discuss latest developments in CGT.

This special issue is a collection of selected papers presented at the Prato Conference on Comparative CGT. It consists of six articles that cover both general and country-specific CGT issues. The authors are colleagues, co-authors, co-editors and former PhD students of Chris. The articles have all been subjected to the usual, rigorous peer review process.

In the opening article, Kristin Hickman provides a comprehensive and critical examination of Chris' major intellectual contributions, namely: CGT; tax compliance costs; and tax system complexity. In her cogent analysis, Kristin has succeeded not only in highlighting Chris' contributions to the tax literature but also connecting the three strands of scholarship produced by him over the last three decades.

The second article is a joint work of Theuns Steyn, Sharon Smulders, Karen Stark and Ilinza Penning, all colleagues of Chris at the University of Pretoria or the nearby University of South Africa. They innovatively apply a systematic review methodology to explore the rich diversity in the CGT literature. Their synthesis of past articles, according to year of publication, country, research design, method of analysis and themes, provides valuable information to tax researchers and tax policy makers.

In the third article, John Hasseldine and Darius Fatemi consider the blurred boundary between capital gains and ordinary income. Focusing on a particular tax case, the authors discuss how experimental research can contribute to wider policy issues including tax complexity, tax reform, and tax professionals' judgements and decisions – particularly those involving client advocacy.

The last three articles deal with country-specific CGT issues. In the Australian case, Brett Freudenberg and John Minas argue against the 50 percent CGT discount to resident individuals but recommend a pragmatic approach of incremental reform of the discount rather than its outright abolition. In the next article, François Vaillancourt and Anna Kerkhoff present a comprehensive and critical review of the evolution of the Canadian CGT in a federal setting from

1972 to 2017. In the final article, Kerrie Sadiq and Adrian Sawyer discuss previous attempts at introducing a CGT into New Zealand and outline some of the key policy choices, based on Australian experiences, that would need to be carefully considered by the New Zealand Government in introducing a separate CGT regime.

We commend this special issue to you and trust you will enjoy it.

John Taylor, TABL, UNSW Sydney
Binh Tran-Nam, TABL, UNSW Sydney
February 2019

From capital gains to tax administration, and everything in between: in honour of Professor Chris Evans

Kristin Hickman*

Abstract

This Essay describes and connects the dots between three strands of scholarship—concerning capital gains taxation, tax compliance costs, and tax system complexity—produced by Professor Chris Evans over two decades.

Key words: capital gains, compliance, complexity

* Distinguished McKnight University Professor and Harlan Albert Rogers Professor in Law, University of Minnesota.

1. PREFACE

I am honoured to participate in this symposium celebrating the scholarship of Chris Evans. I first met Chris—by email in 2009, and then in person in 2010—when he, along with Judith Freedman, Michael Devereux, and Rick Krever, invited me to participate in a symposium entitled *Revenue Authority Discretion and the Rule of Law*. I was a junior scholar at the time. That symposium was my first ever outside the United States. In fact, before I accepted Chris's invitation, I remember asking one of my senior colleagues if he thought the invitation was real or some sort of a scam.

When I arrived in Prato for the conference, Chris welcomed me warmly. He introduced me to people. He encouraged me to attend an upcoming conference on tax administration hosted by the University of New South Wales. When I followed that advice, again, Chris welcomed me warmly. He introduced me to people.

I have had other opportunities to engage with Chris as a scholar since then, including when he accepted my invitation to speak at the University of Minnesota. I have gained new insights from his scholarly work, which is extensive. I have sought his advice, which has been graciously given and gratefully received. I have enjoyed his company when given the opportunity, sharing good food and travel stories, and trying to understand the mysteries and appeal of cricket.

I know I am not alone in benefiting from Chris's mentorship. I know many other scholars with similar stories. And I know many of those scholars because of Chris's efforts to bring us together in exchanging ideas—whether in Prato, in Australia, or elsewhere. I honour Chris today both as a scholar and as a role model for the kind of senior colleague I hope to be.

The topic of the symposium for which this essay is written is comparative capital gains taxation—a topic about which Chris has written extensively. My own work intersects with other strands of Chris's considerable scholarship concerning tax administration and tax simplification. And we approach our work from distinctly different backgrounds—UK and Australia versus United States, business school versus law school. Nevertheless, taking the full body of Chris's work as a whole, one can easily connect the dots from one topic to the next—it's all interrelated. The following essay endeavours to bring those connections to the fore.

2. THE ROLE OF A SCHOLAR

Celebrating a colleague's scholarly career inspires some amount of introspection and reflection regarding this line of work that we have chosen. We think of ourselves as scholars, but what does that mean? Why do we do what we do? And what is it all for?

In defending academic freedom as a professional norm, one American law professor proclaimed that scholars 'search for truth, which will redound to the benefit of society at large'.¹ From my own experience, at least, such a lofty description seems a little too selfless. Certainly many scholars want ideally to contribute meaningfully to the world around them, to make a difference. But a significant motivation—if not the primary

¹ J Peter Byrne, 'Book Review: Matthew W Finkin and Robert C Post, *Neo-Orthodoxy in Academic Freedom for the Common Good: Principles of American Academic Freedom* (2009), and Stanley Fish, *Save The World On Your Own Time* (2008)', (2009) 88(1) *Texas Law Review* 143, 145.

driving force—for many or even most scholars seems instead to be the need to satisfy their own intellectual curiosity, combined with the compulsion to share any resulting findings or insights, irrespective of whether society at large actually benefits or even cares.

In reviewing a biography of Chief Justice Harlan Fisk Stone (who was a professor and dean at Columbia Law School before his appointment to the United States Supreme Court), another American law professor described the scholarly enterprise as ‘to seek out all relevant information, to weigh impartially the information thus secured, and to render an unbiased judgment on it’.² Certainly most scholars endeavour to approach their work with an open mind, rather than merely to reinforce their own preconceived opinions. But the author then went on to talk about scholars as if they were mere spectators of the world around them. To the extent that many scholars do hope their work will contribute meaningfully to the world around them, and actively endeavour to engage the real world and promote their work accordingly, the notion of scholar as spectator seems far too passive.

An essay celebrating the work of Yale Kamisar, a prominent American legal scholar, described a man whose work combined advocacy and scholarship:

[s]cholarship requires thorough research and careful analysis of competing considerations, but having done that, why should the scholar avoid drawing a conclusion as to which side ha[s] the better of the argument, and forgo explaining in detail the grounding for that conclusion?³

At least in the area of tax scholarship, this portrayal of a scholar’s work may come a little closer to the right balance between the ideals of the ivory tower and its relationship with the world outside. The ideal tax scholar combines serious, careful, and impartial inquiry into how the real world actually works with a desire or even a need to engage that real world. Anyone familiar with the work of Chris Evans can see that ideal in action.

3. CAPITAL GAINS TAXATION IN AUSTRALIA AND ELSEWHERE

Tax experts are forever questing for the ideal, or at least best possible, tax system—one that not only raises revenue, but also is equitable, efficient, and simple. The difficulty is that those attributes are often in tension with one another, so that no tax system can maximise all three simultaneously. Each attribute must be sacrificed to some extent to achieve the optimal balance. Moreover, even if we could be sure empirically of the effects of each reform proposal with respect to equity, efficiency, and simplicity—which we cannot—reasonable people will disagree over the extent to which we ought, for example, to preference equity over simplicity, or vice versa. Ultimately, then, the best we can do is contemplate both existing tax laws and reform proposals in terms of equity, efficiency, and simplicity.

² Philip B Kurland, ‘Book Review: Alpheus Thomas Mason, *Harlan Fiske Stone, Pillar of the Law* (1956)’ (1957) 70(7) *Harvard Law Review* 1318, 1318.

³ Jerold H Israel, ‘Seven Habits of a Highly Effective Scholar’ (2004) 102(8) *Michigan Law Review* 1701, 1714.

The subject of capital gains taxation features this tension in spades. Capital gains taxation alone yields a ‘relatively insignificant’ amount of revenue,⁴ yet is a common feature of many countries’ tax laws. In ‘The Australian Capital Gains Tax: Rationale, Review and Reform’, Evans considered capital gains taxation in relation to the classic formulation that the ideal tax system combines equity, efficiency, and simplicity.⁵ He concluded that capital gains taxation is never simple. Capital gains taxation may or may not be entirely efficient, although a case can be made for its efficiency. But capital gains taxation is essential if a tax system is to be equitable. Equity demands that income from capital be taxed the same as income derived from labour. ‘[A] buck is a buck is a buck.’⁶ Moreover, capital gains taxation is essential to backstop the income tax, ‘protect[ing] the integrity of the income tax base by preventing leakage through dressing up or converting income to capital’.⁷ And, of course, governments all over the world rely heavily on income taxes to support their activities.

Globally, however, capital gains taxation suffers from tremendous structural inconsistency across jurisdictions. In ‘Capital Gains Tax—The Unprincipled Tax?’, Evans and Cedric Sandford surveyed capital gains taxation across six English-speaking countries.⁸ Evans and Sandford found a few similarities across jurisdictions—for example, that all of the countries examined taxed capital gains when realised rather than as accrued. But they found more differences than similarities. Not only did rates vary tremendously, but countries differed in whether they integrated capital gains taxation with their income tax, whether they distinguished between short-term and long-term capital gains, whether they treated death as a realisation event, which assets or events they gave preferences, and how they addressed the bunching problems associated with taxing gains only upon a realisation event. Reasons for the inconsistencies included differences in fiscal and political cultures, but also the fact that, while all capital gains represent income as accessions to wealth, taxpayers perceive at least some capital gains as something other than income. In short, however, according to Evans and Sandford, capital gains taxation lacks a single, principled baseline against which to evaluate any one country’s approach. And that lack of a coherent baseline to taxing capital gains means that ‘[t]he “ideal” is unattainable, and the objective should be to find the best second best that can be achieved within the framework of practical constraints and the politics of the real world’.⁹

So how does one go about pursuing that ‘best second best’ approach to capital gains taxation? In ‘Taxing Capital Gains: One Step Forwards or Two Steps Back?’, Evans offered five propositions for that near-ideal capital gains tax.¹⁰ Here, I paraphrase:

- (1) ‘So far as practicable’, treat capital gains like other forms of income.

⁴ Chris Evans, ‘The Australian Capital Gains Tax: Rationale, Review and Reform’ (1998) 14 *Australian Tax Forum* 287, 306.

⁵ Ibid 293-299.

⁶ Ibid 293.

⁷ Ibid 299.

⁸ Chris Evans and Cedric Sandford, ‘Capital Gains Tax—The Unprincipled Tax?’ [1999] 5 *British Tax Review* 387, 388-393.

⁹ Ibid 403.

¹⁰ Chris Evans, ‘Taxing Capital Gains: One Step Forwards or Two Steps Back?’ (2002) 5(1) *Journal of Australian Taxation* 114, 121-122.

- (2) Tax capital gains when realised rather than when accrued to minimise liquidity and valuation issues.
- (3) Treat death as a realisation event.
- (4) Tax capital gains at prevailing marginal income tax rates in order to minimise arbitrage.
- (5) To the extent possible politically, minimise concessions and preferences.

To exemplify particularly that last proposition, Evans recognised that politics may dictate giving preferential treatment to gains associated with the sale of a family home, but he suggested capping the preference.¹¹ For that matter, Evans acknowledged that attaining all five of these propositions would be impossible. Rather, they must be compromised and balanced. But these five propositions offer that theoretical baseline against which to evaluate any single approach to capital gains taxation. Evans went on to evaluate the Australian capital gains tax as of that time against the five propositions.

Of course, Evans's work on capital gains taxation is much more extensive than these three articles. Among other publications, Evans published a book discussing the implications of the Australian and UK approaches to taxing personal capital gains for the operating costs of those countries' tax systems.¹² Also, for several years, Evans co-authored the *Australian CGT Handbook*, 'to provide tax practitioners and students of taxation with a definitive guide to' capital gains taxation in Australia.¹³ Evans's contributions to the literature on capital gains taxation alone would reflect a solid and respectable academic career. But Evans has not limited his work to capital gains taxation.

4. FROM CAPITAL GAINS TAXATION TO COMPLIANCE COSTS

More than two decades ago, the team of Evans, Katherine Ritchie, Binh Tran-Nam and Michael Walpole undertook an extensive study of tax compliance costs in Australia.¹⁴ All had written previously about tax compliance costs. But, this study was a huge effort, surveying more than ten thousand individual and business taxpayers with respect to the 1994-95 income year, undertaken at the behest of the Australian Taxation Office.¹⁵ The team found that federal tax compliance costs in Australia represented '7% of all federal tax revenue and 1.36% of Gross Domestic Product'.¹⁶ Also particularly notable, they observed that tax compliance costs for both individual and business taxpayers are regressive, with small businesses bearing a particularly high burden.¹⁷ By comparison,

¹¹ Ibid.

¹² Chris Evans, *Taxing Personal Capital Gains: Operating Cost Implications* (Australian Tax Research Foundation, 2003).

¹³ See, eg, Gordon Cooper and Chris Evans, *Australian CGT Handbook 2015-16* (Thomson Reuters, 7th ed, 2015).

¹⁴ The full report of the study was published as Chris Evans et al, *A Report into Taxpayer Costs of Compliance* (Australian Government Publishing Service, 1997).

¹⁵ Chris Evans et al, 'Taxation Compliance Costs: Some Recent Empirical Work and International Comparisons' (1998) 14 *Australian Tax Forum* 93, 94-96.

¹⁶ Ibid 99.

¹⁷ Ibid 100, 104.

large business taxpayers experience negative compliance costs, in that their tax benefits outweigh their costs of complying with tax system requirements.¹⁸

That initial study formed the foundation and perhaps inspiration as well for a much more extensive body of scholarly literature on tax compliance costs, not only by the members of that original team but by other tax scholars as well. Evans and Tran-Nam published a critical evaluation of the work of Cedric Sandford and its impact on their own scholarship and that of other tax administration scholars.¹⁹ With one or more of that original team as well as with later co-authors, Evans's work in the area of tax compliance costs in Australia prompted him to compare the Australian experience with that of other countries—as, for example, in 'The Tax Compliance Costs of Large Corporations', with Tran-Nam and Philip Lignier.²⁰ In a much more recent study, Tran-Nam, Evans and Philip Lignier demonstrated that tax compliance costs in Australia continue to be large and regressive, notwithstanding at least some efforts at amelioration.²¹

Perhaps most helpfully to the larger body of tax compliance cost scholarship, however, after wrapping up their own study, that initial group of Evans, Ritchie, Tran-Nam and Walpole published an article, 'Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia', outlining their methodological approach to evaluating tax compliance costs, along with the many choices and the thinking that went into that methodology.²² Such documentation is of tremendous value and service to tax administration scholars worldwide.

Katherine Ritchie is, unfortunately, no longer with us. But the work of Evans, Ritchie, Tran-Nam, and Walpole in this area laid a foundation that helped make the University of New South Wales one of the world's leading academic centres—if not *the* leading academic centre—for the study of tax compliance costs. The importance of Evans's work on tax compliance costs for the field of tax administration cannot be underestimated.

5. FROM COMPLIANCE COSTS TO COMPLEXITY

Too often, in designing the ideal tax system, tax academics lose sight of the implications of tax policy reform for the day-to-day of tax administration and tax compliance. The most equitable and efficient tax reform proposal from the perspective of economists may prove to be frustratingly complicated for the administrators tasked with implementing it, for the taxpayers who must comply with it, or both. Although tax scholars like to talk about tax system design in terms of equity, efficiency, and simplicity, frequently, simplicity gets short shrift.

On several occasions, Evans has acknowledged that, although capital gains taxation is essential for an equitable tax system, it is unavoidably complicated. Particularly in his

¹⁸ Ibid 103.

¹⁹ Binh Tran-Nam and Chris Evans, 'The Impact of Cedric Sandford on the Discipline of Tax Compliance Costs' (2002) 17 *Australian Tax Forum* 389.

²⁰ See, eg, Chris Evans, Philip Lignier and Binh Tran-Nam, 'The Tax Compliance Costs of Large Corporations: An Empirical Inquiry and Comparative Analysis' (2016) 64(4) *Canadian Tax Journal* 751.

²¹ Philip Lignier, Chris Evans and Binh Tran-Nam, 'Tangled up in Tape: The Continuing Tax Compliance Plight of the Small and Medium Enterprise Business Sector' (2014) 29(2) *Australian Tax Forum* 217.

²² Binh Tran-Nam et al, 'Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia' (2000) 53(2) *National Tax Journal* 229.

early work, Evans accepted that complexity as the cost of equity. As his compliance work correspondingly observes, however, complexity drives up compliance costs. Perhaps recognising that relationship inspired Evans to contemplate tax simplification. As with capital gains taxation and compliance costs, Evans has written quite a lot on the topic of tax complexity and tax simplification.

Indeed, in 2012, Evans himself connected the relevant dots among these topics. In ‘Tax Governance Issues: Managing System Complexity’, Evans observed that most taxpayers voluntarily do their best to comply with the tax laws.²³ They file their returns and pay their taxes. They generally trust that their tax system is fair and efficient. They have faith, and it is that faith that drives their voluntary compliance.

But tax system complexity, as Evans recognised, ‘gives rise to both intentional and unintentional non-compliance’.²⁴ That non-compliance ‘leads to tax revenue losses and it also causes deadweight losses’.²⁵ Thus, ‘tax complexity itself is a kind of tax’.²⁶ Pulling together the costs of complexity with his other work, however, Evans focused particularly on the relationship of compliance costs and the corresponding disincentive to engage in entrepreneurial activity, although he also acknowledged that complexity ‘reduces the [tax] system’s transparency and undermines trust in its fairness’.²⁷

Tax system complexity is mostly the fault of the legislature. Revenue authorities have no choice but to implement what the legislature enacts. Yet revenue authorities receive the blame when taxpayers are unhappy with the tax system. Tax specialists in the United States frequently contend that fear of the Internal Revenue Service motivates people to comply with the tax laws. But fear breeds resentment, which discourages compliance. By embracing a responsive regulation approach to tax administration and enforcement, Australia is at least somewhat more advanced in recognising that fear is not always the best way to motivate taxpayer compliance.²⁸

Regardless, toward this same goal, in ‘Tax Reform and “Rough Justice”: Is It Time for Simplicity to Shine?’, Evans and Jason Kerr suggested that the time has come for greater focus on simplifying the tax system, even at the expense of some amount of equity and efficiency.²⁹ The article is mostly a commentary on the Australia’s Future Tax System Review, or Henry Review, and its failure to go far enough in pushing for simplification of the personal income tax.³⁰ Nevertheless, the article offers two additional observations worth noting.

²³ Chris Evans, ‘Tax Governance Issues: Managing System Complexity’ (2012) 31(1) *Economic Papers* 30.

²⁴ Ibid 32.

²⁵ Ibid.

²⁶ Ibid (quoting Sen. Max Baucus, Chair of the US Senate Finance Committee).

²⁷ Ibid (quoting the US President’s Economic Recovery Advisory Board 2010 report, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation*).

²⁸ See, eg, Sagit Leviner, ‘A New Era of Tax Enforcement: From “Big Stick” to Responsive Regulation’ (2009) 42(2) *University of Michigan Journal of Law Reform* 381, 410-425 (exploring the Australian taxing authority’s pursuit of the ‘responsive regulation’ model).

²⁹ Chris Evans and Jason Kerr, ‘Tax Reform and “Rough Justice”: Is It Time for Simplicity to Shine?’ (2012) 27(2) *Australian Tax Forum* 387, 390-391.

³⁰ For further commentary by Evans and co-authors regarding the aftermath of the Henry Review, see also Binh Tran-Nam et al, ‘Managing Tax Complexity: The State of Play after Henry’ (2016) 35(4) *Economic Papers* 347.

The first is a distinction ‘between legal simplicity and effective simplicity’.³¹ Anyone who has read the legal literature on rules versus standards, or the more contemporary literature on principles-based taxation and regulation, should intuitively appreciate that there is a difference between simplicity in the law and simplicity in the implementation and administration of that law. Policy-makers make a mistake in equating the two.

Second, Evans and Kerr recognise and call out the Henry Review for a mismatch between the political rhetoric of tax simplification and the reality of tax reform proposals.³² We see this in the United States as well. Political actors, and political reports, often speak of a need to make particularly the personal income tax simpler and easier for non-tax specialists to follow. In the United States, for example, politicians frequently express the desire to make individual income tax returns no larger than a postcard.³³ But when it comes to the actual policy reforms needed to accomplish that goal, all of the political will goes the other way. Existing tax expenditures are often viewed as untouchable. Politicians and tax scholars alike routinely propose new and expanded tax expenditures to satisfy other policy goals, at the expense of tax simplification.

6. WHEN ALL ELSE FAILS, CALL FOR BACKUP

The academic enterprise is often rewarding but sometimes frustrating. Scholars continue to diligently survey the data, evaluate competing theories, and offer our best suggestions for improving the law and the societies in which we live. We hope to inspire real, practical change, but often our voices go unheeded by those who hold the power actually to effect that change. Yet, like Sisyphus rolling that rock back up the hill, we keep at it—collecting more data, considering new theories, and developing more proposals for reform. When pursuing real world change, it helps sometimes to have a little outside assistance.

In ‘The Office of Tax Simplification: The Way Forward?’, with Jeremy Sherwood and Binh Tran-Nam, Evans considered the efficacy of the UK’s Office of Tax Simplification (OTS).³⁴ The OTS was established as a small, temporary office within HM Treasury with the mission of pursuing tax simplification. As documented by Evans, Sherwood and Tran-Nam, the OTS has enjoyed some success in that direction.

Much of what the OTS has accomplished seems best described as ‘small ball’. Sensibly, given its size and its temporary status, the OTS has eschewed large, sweeping reform proposals in favour of building relationship and pursuing small and achievable initiatives: for example, ‘a new cash basis for small businesses, the abolition of nearly 40 minor tax reliefs and replacement of the unwieldy paper-based HM Revenue and Customs approval process for employee share schemes with an automated self-approval system’.³⁵ But small simplification measures, taken collectively, can make a measurable difference. Describing the OTS’s achievements as ‘both encouraging and welcome’,

³¹ Evans and Kerr, above n 29, 392.

³² Ibid 401-406.

³³ See, eg, Thomas Franck, ‘Republicans say you can file your taxes with a postcard if new bill passes; H&R Block shares drop’, *CNBC* (2 November 2017), <https://www.cnbc.com/2017/11/02/republicans-say-you-will-file-your-taxes-with-a-postcard-if-new-bill-passes.html>.

³⁴ Jeremy Sherwood, Chris Evans and Binh Tran-Nam, ‘The Office of Tax Simplification: The Way Forward?’ [2017] 2 *British Tax Review* 249.

³⁵ Ibid 253.

Evans, Sherwood and Tran-Nam suggest that other countries mimic the OTS model and offer key principles for attaining similar success.³⁶

7. CONCLUSION

It is difficult to summarise twenty plus years of scholarly accomplishments in a single essay. I harbour no illusions that I have done more than scratch the surface of Evans's prodigious scholarly career in these pages. And Evans clearly is not yet finished with this work. For example, at the symposium in his honour, after outlining all of the above, I was handed my very own, hot-off-the-presses copy of *Comparative Taxation: Why Tax Systems Differ*, co-authored by Evans with John Hasseldine, Andy Lymer, and Robert Ricketts, which draws from and builds on an earlier book by Cedric Sandford with a similar title, and which covers all of the above-described topics and more. Keeping up with Chris Evans is a daunting task. He is a scholar's scholar—a tax scholar to emulate, and to honour, as we do with this symposium.

³⁶ Ibid 262-263.

Capital gains tax research: an initial synthesis of the literature

Theuns Steyn,¹ Sharon Smulders,² Karen Stark³ and Ilinza Penning⁴

Abstract

No structured overview of the extent of capital gains tax research and its dimensions in academic journals exists. This article explores the rich diversity of capital gains tax literature in certain electronic databases in respect of recent academic articles published in different ranking categories of journals. The results are synthesised using a systematic review methodology. Selected *a priori* determinants are used as an analytical foundation to synthesise specific themes emanating from the articles. This research provides valuable information for researchers and other policy-makers in the broader tax environment wishing to explore the capital gains tax phenomenon as a research topic.

Key words: capital gains tax, systematic review, systematised review, journal rankings

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1. INTRODUCTION

‘History is not what happened but what human beings do to acquire reliable knowledge about what happened and how they convert such knowledge into an enlarged and enriched understanding of reality and their place in the world’ (Curtis, 1982, p. 56).

This trait of humankind, wanting to acquire knowledge of what happened and to learn from this knowledge about what still may happen, has given rise to an ever-growing body of knowledge. This body of knowledge is growing exponentially, especially since the worldwide reach of the internet. Digital publication of academic articles has resulted in academics’ research being more visible and accessible internationally. Together with the ever-increasing growth in modern open access academic journals, a researcher’s ‘discoverability file’ may overflow to such an extent that it is becoming virtually impossible to navigate the literature of a specific phenomenon, even for one in a relatively small domain (Booth, Sutton & Papaioannou, 2016, p. 13; Conrad, 2017, p. 35).

The capital gains tax (CGT) literature is sizeable and the current state of academic journals containing articles related to capital gains tax is not that readily available for researchers concerned with this phenomenon. Although there are numerous individual studies focusing on CGT, for instance Chatalova and Evans (2013) and Evans, Minas and Lim (2015), at present no structured overview of academic journal publications dealing with CGT exists.

Burman (2009) posits that there is understood by many people to be a silver bullet theory that no aspect of tax policy is more important for economic growth than the way we tax capital gains. However, that author has also argued that cutting capital gains taxes now will not necessarily improve the economy and raising them may not adversely affect the economy as many other things have changed at the same time as gains rates and many other factors now affect economic growth (Burman, 2012). Be that as it may, while it used to be that only the rich had to worry about capital gains, today, with more and more individuals being able to invest, capital gains tax has become more a part of many individual’s everyday way of life (IVDGL, 2017).⁵ The legislative history of capital gains taxation under the modern income tax is divided into policies that have fluctuated widely from severe restrictions to liberal allowances (Boehl & Fisher, 2017; Wells, 1949). Numerous ongoing debates about these CGT policies, for example, in the United States, have emerged in the literature (Jacob, 2018).

Bearing these aspects in mind, and as far as we are aware, there has been no systematic review of journal articles focusing on CGT. Thus the main purpose of this article is to perform an initial exploration of the rich diversity of CGT literature in academic journals (of different ranking categories) and to synthesise the results of the review. This enhanced understanding of the CGT literature will provide valuable information to future researchers and other policy-makers in the broader tax environment wishing to explore the CGT phenomenon as a research topic. Determining whether there are certain characteristics of publications that are more prevalent the ‘higher’ the journal is

⁵ See, e.g., IVDGL, ‘Investor view – Importance of capital gains tax’, <http://www.ivdgl.org/pages/c-filertypes/capitalgainloss.html> (accessed 31 August 2017).

ranked will also assist academics in evaluating which journals their research might be more suitable to be published in and so assist in managing their academic performance requirements. Ultimately an initial foundation will be laid in relation to the most recent CGT literature, highlighting the gaps and potential areas for further research in this field of taxation.

This article is set out as follows. Section 2 explains the research methodology and design used in the study. Section 3 sets out the discussion and analysis of the results of the research. Section 4 concludes with a synthesis of the research findings, a summary of the limitations and the implications of the findings for future research.

2. RESEARCH METHOD

This study is descriptive in nature and adopts a systematic review, more specifically a systematised review, of the literature as a research strategy. A systematic review is a research methodology that is considered to be objective, systematic, transparent, and replicable (Booth et al., 2016). This structured approach for reviewing the literature aims to minimise bias, to provide justifiable results, and to precisely document assumptions, procedures, and conclusions in a clear manner (Booth et al., 2016). Just like any other high quality research methodology, systematic reviews are clearly documented and follow a research process that presents results that are justifiable (Crossan & Apaydin, 2010, p. 1156). A systematic review normally aims to be exhaustive and comprehensive in the literature search (Grant & Booth, 2009, p. 95). However, the present study does not aim to be a comprehensive literature search, but is rather an initial exploration of the literature utilising a systematic search process to obtain and review the most recent academic journal publications in this field of taxation.

There are numerous types of systematic reviews, for instance critical reviews, integrative reviews, literature reviews, meta-analysis, meta-synthesis, mapping reviews, and systematised reviews (Grant & Booth, 2009, p. 94-95). Due to the limitation in the scope of the review, the present study adopts a systematised review approach. This approach is used when the aim of the systematic review is not comprehensive (Grant & Booth, 2009, p. 94-95). The systematised review process in this study can be divided into four distinct phases, namely data collection (section 2.1), inclusion and exclusion criteria (section 2.2), quality assessment of publications (section 2.3) and data analysis (section 2.4). The results are presented and discussed in section 3. The scientific rigour, paramount for quality research, is demonstrated in each of these phases in the following sections.

2.1 Data collection phase

In this initial phase of systematically collecting data, search efforts were directed towards well-recognised scientific databases, namely Scopus, ProQuest, EBSCOhost and ScienceDirect. These electronic databases were selected because most articles in the taxation discipline (from a South African perspective) are published in journals in these databases and they are the ones that the authors' institutions had access to. A limitation to this study is thus that only electronic documents were considered and furthermore, not all databases, especially ones such as the legal databases containing CGT articles, were incorporated into this study, mainly due to funding constraints. However, as this is an initial exploration and synthesis of the literature, the researchers plan to expand their search to other relevant scientific databases and also consider this type of research for different countries.

The process of searching for and selecting relevant academic publications followed a strict systematic approach to ensure that this phase can be viewed as objective, systematic, transparent and replicable (Nguyen, Tran-Nam & Grewal, 2012). As a point of departure, the search was based on the following keywords: ‘capital gains tax’, ‘tax on capital’ and ‘capital tax’ (including variations thereof, for instance ‘taxing capital gains’). Due to the substantial number of articles found, only those publications where one or more of the keywords appeared in the title of the publication were selected for further analysis. Although this is acknowledged as a further limitation, the reason for this selection was to limit the scope to only those articles with a predominant focus on CGT-related issues.

The following numbers of publications in different categories complied with the above limitations and keyword selection criteria and were subsequently recorded on software analysis program Qiqqa: 76 journal articles, 1 book chapter, 16 unpublished papers and 5 technical reports. Certain inclusion and exclusion criteria were then applied to these initially identified publications.

2.2 Inclusion and exclusion criteria

The initial inclusion criterion used to differentiate the publications for analysis in this study was the ‘type of publication’ – specifically, only articles published in academic journals were selected for further analysis. Excluded from these selected academic journal articles were nine articles dealing with a wealth tax or the capital structure rather than capital gains tax. These articles were excluded since the topics are broader than the CGT elements that are the focus of this study. Another study was excluded as it also did not deal with capital gains tax but rather with the effect of capital gains on income inequality.

Applying these inclusion and exclusion criteria, 66 academic journal articles formed the basis for the synthesis.

The next exclusion criterion concentrated on the publication dates of the articles. The researchers were interested in the most recent (last five years) CGT publications and thus excluded any articles that were not published between 2012 and 2016. Forty articles complied with this criterion – see Appendix A.

As the aim of this article is to evaluate the CGT research in journals of different ranking status, the next phase of the research process was to perform a quality assessment on the journals in which these 40 articles were published.

2.3 Quality assessment of journals

McKinnon (2013) states that it is widely acknowledged by scholars that some journals are of a higher quality than others. However, Vogel, Hattke and Petersen (2017) argue that the ranking of journals has been criticised for favouring certain paradigms, theories and methods while discriminating against others and they state that there is little robust evidence on the criteria that are implicit to journal rankings. Whilst bearing the unresolved nature of journal rankings in mind, the current study adopted the Australian Business Deans Council journal quality list (ABDC list) as the point of reference to assess the quality and rating of the journals in which the 40 articles were published. The ABDC list was established in 2007 for the purpose of rating the quality of journal publications (‘evaluating research output’: Moosa, 2018, p. 143) and, despite the

controversy surrounding journal rankings, it is widely accepted amongst academics as a reliable indicator of quality (Vogel et al., 2017).

The ABDC list is based on four mutually exclusive rating categories labelled A*, A, B and C (Australian Business Deans Council, 2016). These quality rating categories are defined as follows:

A*: the highest quality category (comprising the top 5-7% of the journals in the given field of research);

A: the second highest quality category (comprising the top 15-25% of the journals in the given field of research);

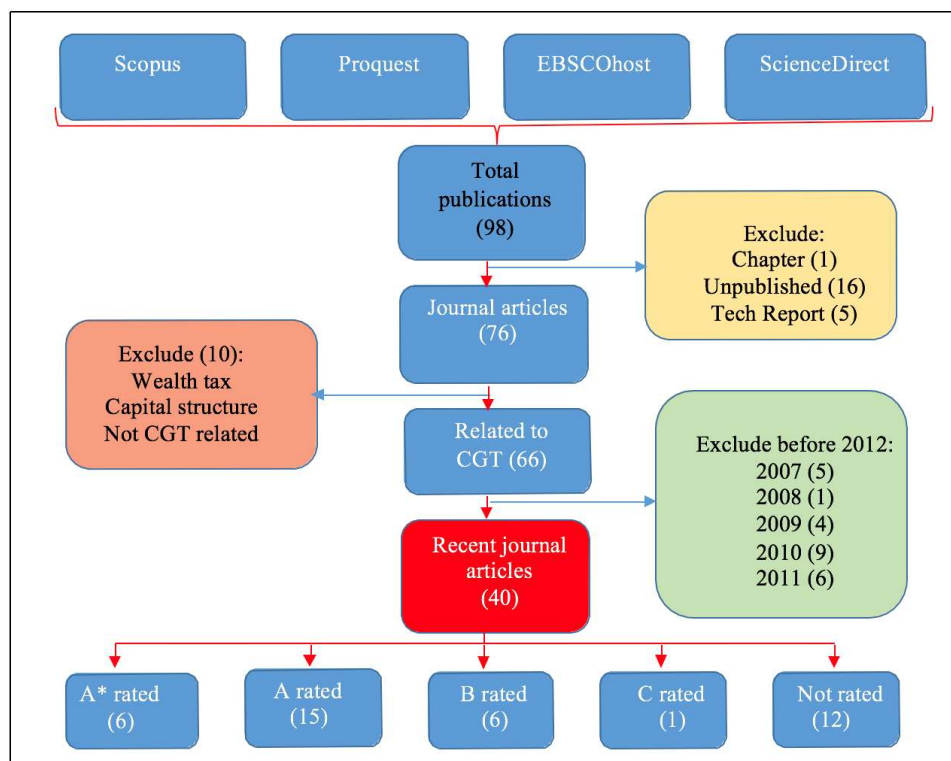
B: the third highest quality category (comprising the top 35-40% of the journals in the given field of research); and

C: the fourth highest quality category (comprising the remaining recognised quality journals in the given field of research).

Each of the 40 journal articles selected under phase one of the systematised review process was scrutinised to determine what the rating of the journal (in which the article was published) was in terms of the ABDC list – that is, either A*-rated, A-rated, B-rated, C-rated or not rated at all, as explained above.

Applying these rating criteria, the articles were distributed as follows according to the journal quality rankings: six (6) A*-rated articles, fifteen (15) A-rated articles, six (6) B-rated, one (1) C-rated and twelve (12) non-rated articles. Each article was analysed in order to provide an overview of the CGT literature but also to determine whether there are certain characteristics of publications that are more prevalent the higher the journal is ranked.

A schematic representation of the systematised review process adopted (as explained above) to select the articles for further analysis is provided in Figure 1 below and a list of the A*, A, B, C and Not rated journals is included in Appendix B.

Fig. 1: Systematised Review Process

2.4 Data analysis

In this phase of the systematised review, the 40 selected articles were analysed and the metadata was coded in terms of the following initial *a priori* determinants:

- *Year of publication*: the year in which the article was published in the journal under review;
- *Country perspective*: the country(ies) in respect of which the research in the article was performed;
- *Tax policy, legislation and governance*: articles in which the primary focus was on tax policy, legislation and governance;
- *Research design*: the research design, methodology and analysis techniques adopted by the researchers in each article; and
- *Themes*: the main theoretical theme(s) (and sub-themes where relevant) under investigation in the research article.

The year of publication and country perspective were easily identifiable. Tax policy was analysed according to the following constructs: tax policy principles (for example equity and simplicity) and tax policy design (for example tax rate regime). The construct for tax legislation was case law analysis and for tax governance it was various aspects related to tax administration.

The research design determinant was analysed according to the following constructs (see the conceptual framework in Table 1 below): design, method and analysis techniques. Each

of these constructs, were further broken down into broad sub-categories as illustrated in Table 1.

Table 1: Research Design Conceptual Framework

Design	Method	Analysis*
Historical	Doctrinal Archival	Thematic analysis (e.g. narrative, systematic, comparative)
Descriptive	Observation Systematic review Case study Survey Interviews	Thematic analysis (e.g. narrative, systematic, comparative) Descriptive statistics
Experimental	Experiment (including lab, field or natural experiments) Simulation	Correlation Regression Numerical Factor Asymptotic

* Analysis techniques may be used for more than one method

Each of the research design constructs are defined (for the purposes of this study) below, and were used as the basis for analysing the articles into the different research design constructs:

Historical research design – involves collecting, verifying, and synthesising evidence from the past to establish facts that defend or refute a hypothesis or future event;

Descriptive research design – takes available data and tries to gain some insight out of that data using various analysis techniques. It can show a link between two events but not how that relationship actually works; and

Experimental research design – explains a connection between two variables and generally entails manipulating an independent variable to observe its effect on the dependent variable.⁶

The method and analysis techniques set out in Table 1 are by no means comprehensive, but consist of existing techniques as defined by Pallant (2006) and Sekaran and Bougie (2013) which were considered to be relevant for research in the field of taxation. These techniques were expanded, where relevant, based on information obtained during the analysis process.

To ensure the validity and reliability of the analysis process, the analysis and coding of the selected articles in terms of the above *a priori* determinants were performed by three of the authors of this article independently. To check for accuracy and consistency in this process, the results were compared and in the event of differences in opinion, the fourth researcher acted as an arbitrator in order to reach an acceptable decision about each criteria. The results emanating from analysing each of the articles according to the above discussed determinants is discussed further in the next section.

⁶ See, e.g., R V Labaree, 'Organizing your social sciences research paper, Types of research designs', University of Southern California Library Guides, <http://libguides.usc.edu/writingguide/researchdesigns> (accessed 31 August 2017).

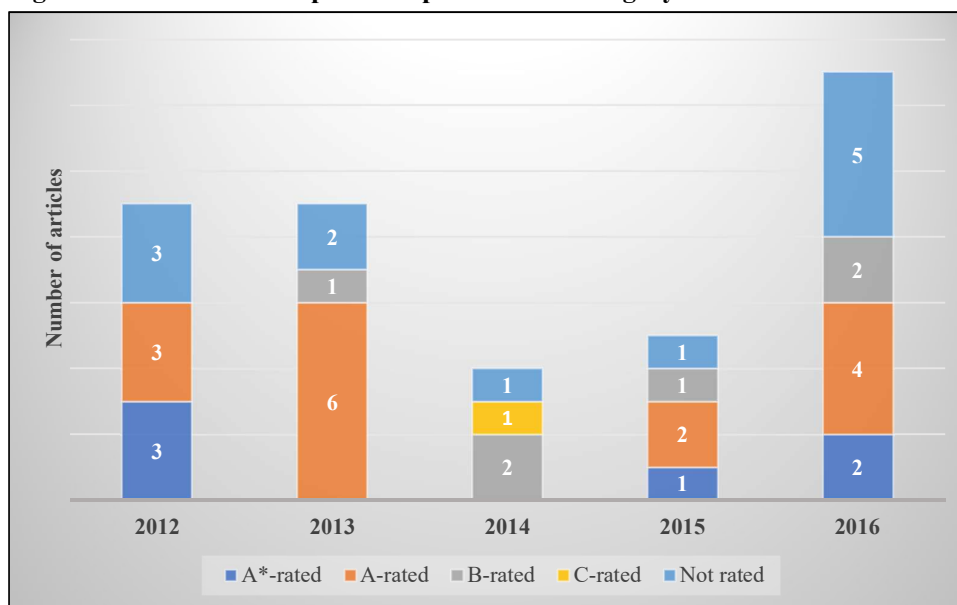
3. PRESENTATION OF RESULTS AND DISCUSSION

The results of the systematised review are discussed in order of the determinants as was set out in section 2.4.

3.1 Year of publication

The year in which the articles were published in the journals under review is set out in Figure 2 below.

Fig. 2: Articles Published per Year per Journal Category

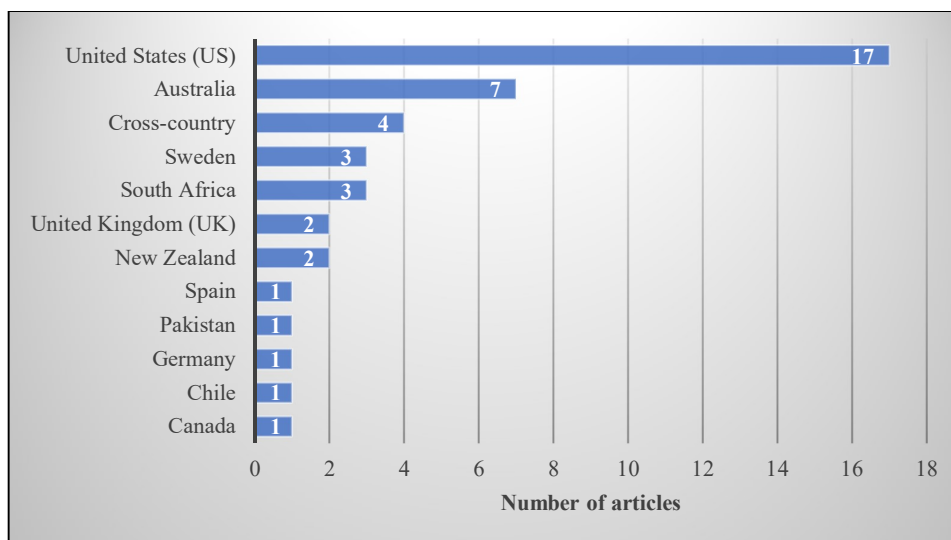


Of the forty (40) articles reviewed, most of them were published in 2016 (13), 2013 (9) and 2012 (9). Articles in non-rated journals were published throughout the period with the bulk being published in 2016. No A*-rated articles were published in 2013 and 2014, no A-rated articles were published in 2014 and no B-rated articles were published in 2012. Reasons for these findings are not readily apparent and this requires further research.

Although many articles were published in 2012 and 2013, a spike in CGT research (especially in non-rated and A-rated journals) took place in 2016, indicating an increase in quality CGT research in recent years – perhaps signifying that there are still various elements of the CGT regime that are unclear or require more attention from scholars and governments alike.

3.2 Countries under consideration

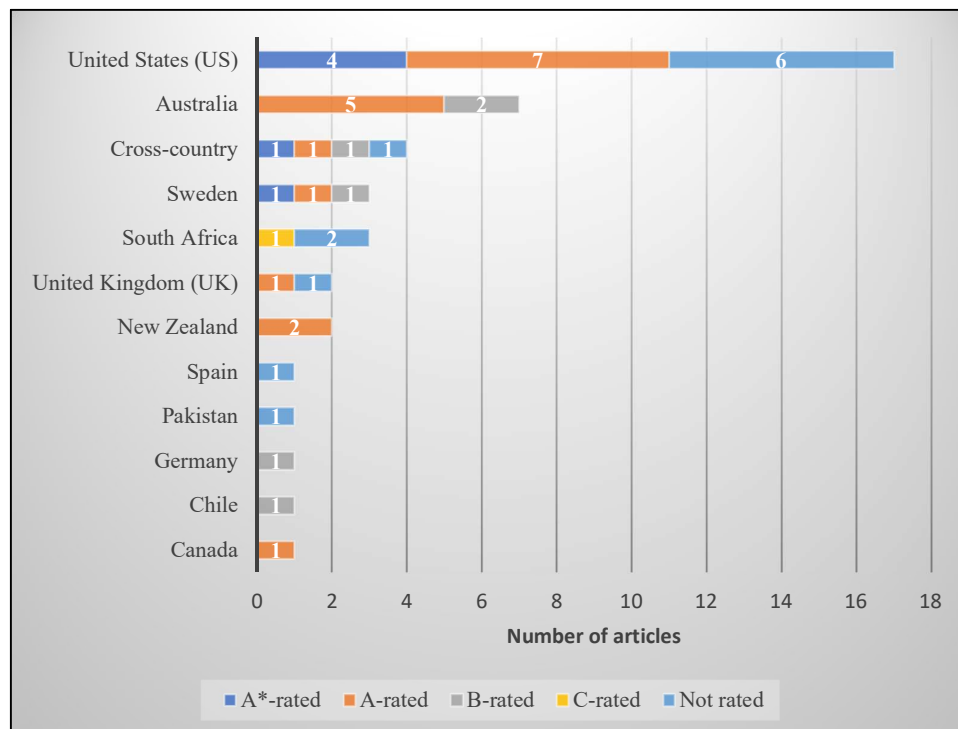
The countries that were under consideration in the articles reviewed are set out in Figure 3 below.

Fig. 3: Countries Considered in Articles

Four articles did not deal with a specific country but instead considered various countries when analysing the CGT aspects. CGT in the United States (US) appears to be predominant in the research scope of academics. Australia is the next country where academics are focusing their research efforts on CGT, followed by Sweden/South Africa and the United Kingdom/New Zealand. Other countries in which CGT research was performed include Spain, Pakistan, Germany, Chile and Canada.

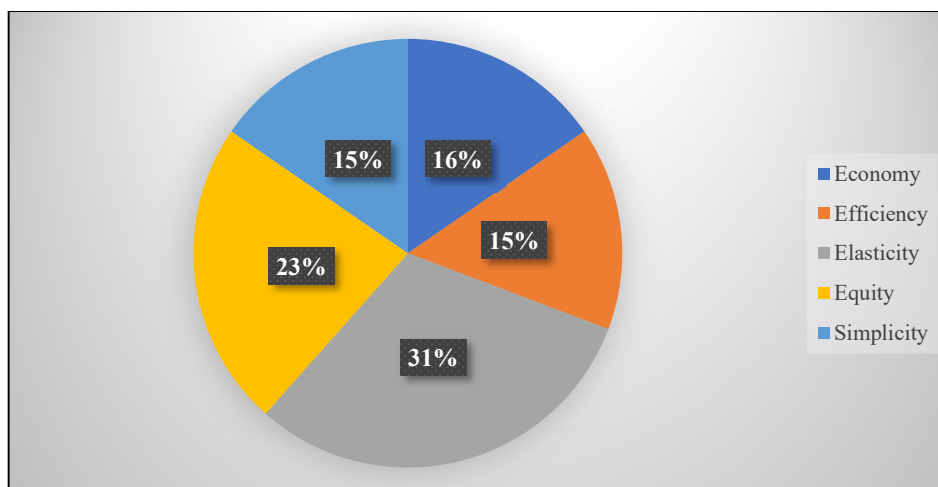
Reasons for the US being under scrutiny could be because of the heavy tax burden that it places on savings and investments for its citizens (Alm, 2018). Complexity of the CGT regime could be another reason for the large number of research publications coming from the US, and from Australia for that matter (Australian National Audit Office, 2015; Burton & Karlinsky, 2016). Further consideration as to the particular aspect of CGT (themes) that is evaluated in each of these countries will be provided in section 3.5 below.

A cross tabulation (see Figure 4) was performed to establish which countries were primarily under consideration in the differently ranked journals. It is evident that the A*-rated journals have predominantly focused on US CGT issues with only one article relating to Sweden in particular. The countries under consideration in the other A*-rated journal article were not specified in the articles itself. From an A-rated journal perspective, it appears that all countries have a representation but again the US and Australia appear to dominate their CGT research focus. From a B-rated journal perspective, Australia is the dominant country being considered and from a C-rated perspective, South Africa is the only country that featured. For non-rated journals, the US is once again the predominant country of interest.

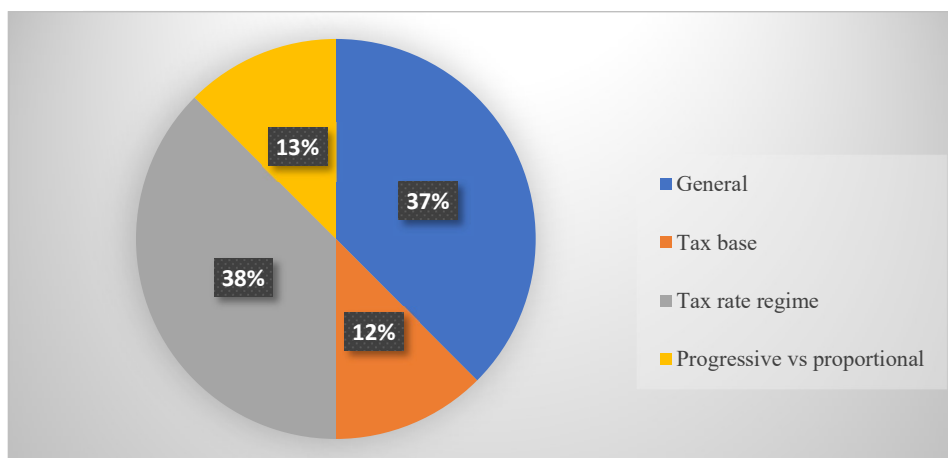
Fig. 4: Countries Considered by Journal Category

3.3 Tax policy, legislation and governance

Every tax in operation represents a compromise between tax policy, tax law and administrative considerations. Five specific policy principles four broad policy design constructs were identified from the articles. Figures 5A and 5B illustrate the constructs that emerged under the tax policy determinant.

Fig. 5A: Tax Policy Principles

Elasticity⁷ is the predominant policy principle aspect (31%) considered in the research, followed by tax equity (23%), economic design (16%), simplicity (15%) and efficiency (15%). The A-rated journal articles dominate this research space and appear to be focusing on all the policy aspects other than the economic effect of CGT (which is considered by two articles in A*-rated journals). The B-rated journals focused on elasticity and equity whereas no tax policy principle was specifically addressed in both the C-rated and not-rated journal articles.

Fig. 5B: Tax Policy Design

From a tax policy design perspective, 38% of the articles considered the tax rate regime, 13% considered the tax base, 12% the progressive versus proportional nature of CGT

⁷ Although Adam Smith originally presented four canons of taxation (namely, equality, certainty, convenience and economy), further canons have since been developed to better suit modern economies. These additional canons are productivity, simplicity, diversity, elasticity and flexibility (Meer, 2013). Elasticity as explained by Meer and adopted for purposes of this article means taxes which can easily be increased or decreased.

and the remainder considered various CGT design aspects and did not focus on one aspect of tax policy design. The tax rate regime and the progressive versus proportional nature of CGT were the predominant focus of the most prestigious journals (A*-rated). Overall, it is evident that the main focus of the research from a policy perspective is on the elasticity of the CGT regime and the effect of the rate thereof.

One article specifically dealt with tax administration. This article highlighted the importance of the balance between the three dimensions, being tax policy, tax law and tax administrative considerations with specific emphasis on tax administration.

3.4 Research design

The research design, methodology and analysis techniques used in the articles under review is explained in Figures 6 to 8 below.

Fig. 6: Research Designs by Journal Category

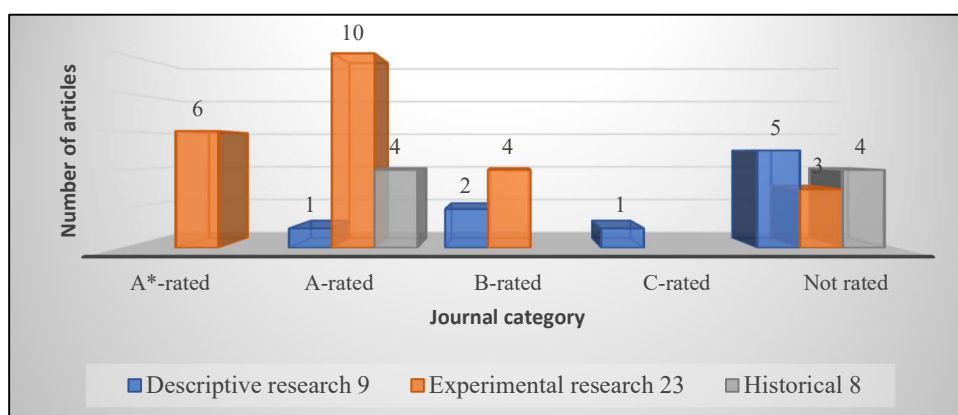
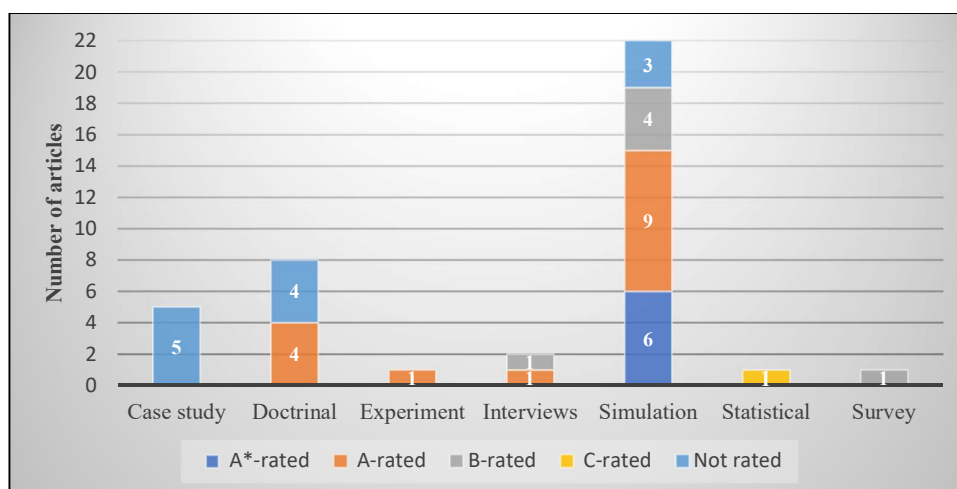


Figure 6 illustrates that 58% of the articles followed an experimental research design process. Twenty-two per cent used a descriptive research design process and 20% used a historical research design process. The prestige journals (A*, A and B-rated journals) appear to have published articles that use the experimental research design process more than any other design process.

From a research methodological perspective (see Figure 7), the simulation method (using mostly model building) was the method used by the majority of authors of the articles to conduct their research. Others authors used the doctrinal (8), case study (5), interviews (2), experimental (1), statistical (1) and survey (1) methods.

Fig. 7: Research Methods by Journal Category

The techniques used to analyse the articles are indicated in Figure 8 below along with the incidence of these techniques in the rated journals.

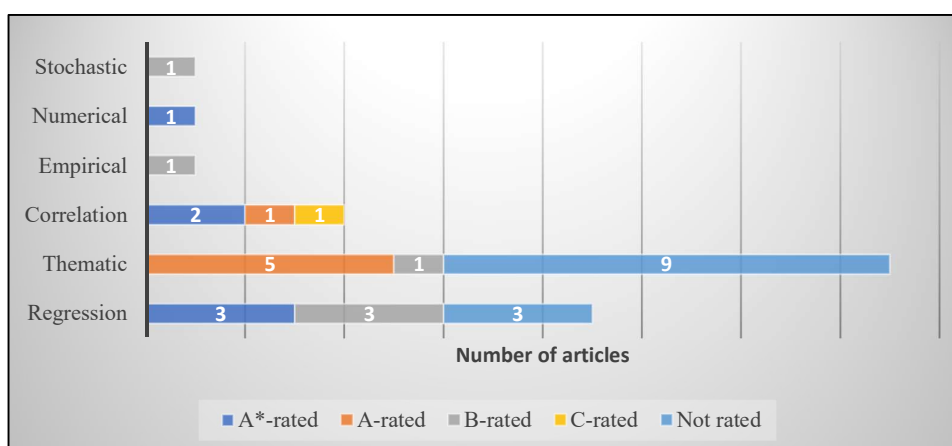
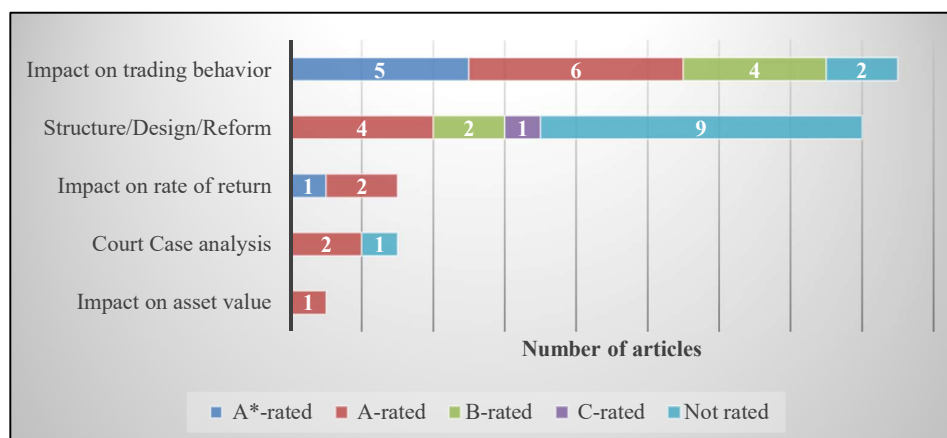
Fig. 8: Analysis Techniques by Journal Category

Figure 8 reveals that regression analysis is the dominant technique used in the articles to analyse the various aspects of CGT (especially prevalent in A-rated journals). A thematic and correlation analysis is also used frequently by authors publishing in the non-rated (9) and A-rated (5) journals. Other analysis techniques less frequently used include empirical, numerical and asymptotic analysis. Notwithstanding this limited use, from a journal ranking perspective, regression analysis techniques dominate the A*-rated journals but numerical and correlation techniques have also featured in these journals.

3.5 Themes of capital gains tax under consideration

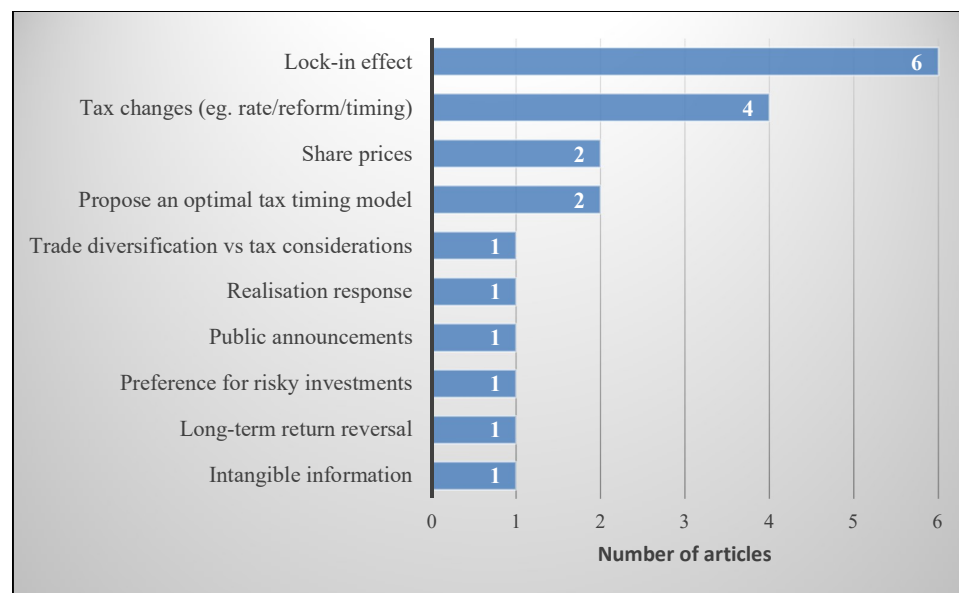
A high-level overview of the various themes considered by the articles is presented in Figure 9 below.

Fig. 9: CGT Themes by Journal Category

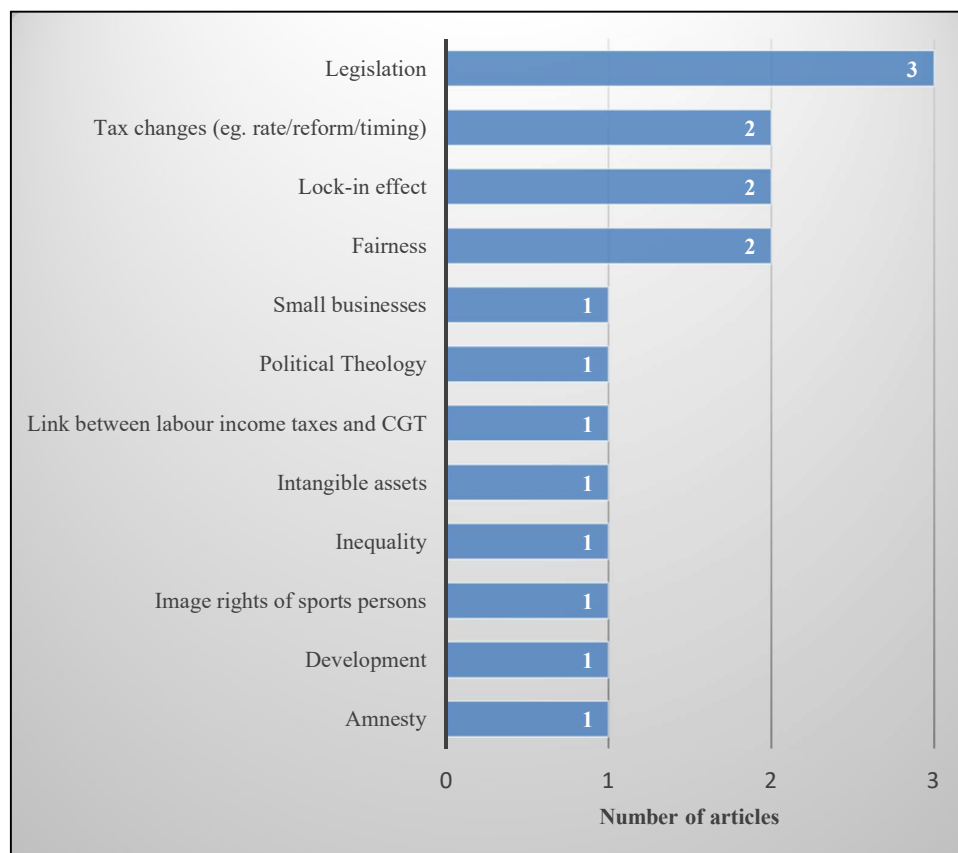


The five broad themes covered by the articles reviewed include (in order of dominance): the impact of CGT on trading behaviour, the structure, design and/or reform of CGT, the impact of CGT on the rate of return for an investor, court case analyses and the impact of CGT on asset values. The A* and A-rated journals tended to focus more on the impact on trading behaviour whereas the non-rated journals tended to focus on the structure/design/reform aspects of a CGT.

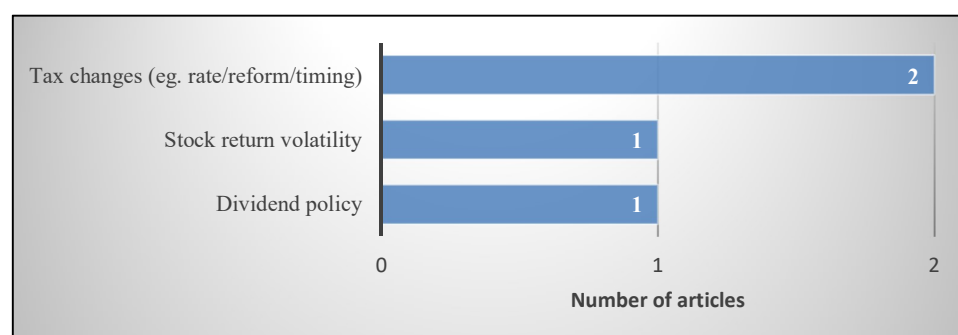
When the impact of CGT on trading behaviour is analysed in more detail, it is evident that the lock-in effect is the subject of most interest to researchers. The lock-in effect is described in the literature as an impediment to selling one asset and replacing it with another which has a higher pre-tax return – that is, taxpayers will be responsive to a lowering of the CGT rate and will choose to realise accrued capital gains once they consider the CGT rate to be acceptably low (Minas & Lim, 2013). The tax changes (for instance, tax rate changes, reforms or timing of the changes) is also an area that has received attention by various researchers. Figure 10 summarises the sub-themes that relate to the impact of CGT on trading behaviour.

Fig. 10: Impact of CGT on Trading Behaviour (Sub-Themes)

The second most dominant CGT research theme is structure/design/reform of a CGT system. When the articles dealing with this theme are analysed in more detail (see Figure 11), various sub-themes emerge. The effect of the CGT legislation, tax changes, the lock-in effect and the fairness of the CGT legislation are the main topics of research interest. Two of these themes (the second and the third) also featured in articles (mainly in A* and A-rated journals) dealing with the impact of CGT on trading behaviour, highlighting the importance of these particular aspects from a research perspective.

Fig. 11: The Structure/Design/Reform of a CGT

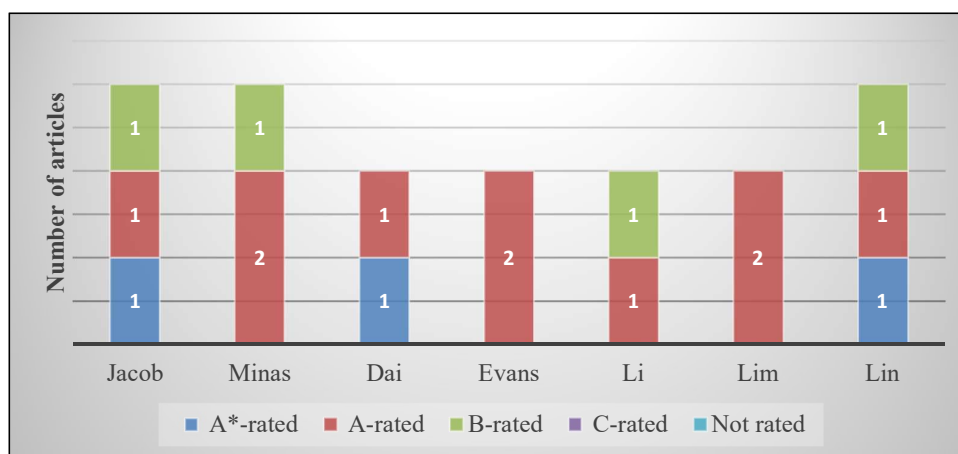
The third most dominant CGT research theme is the impact of CGT on the rate of return. When the articles dealing with this theme are analysed in more detail (see Figure 12) it is evident that the dominant issue at hand is the tax changes (as mentioned above) but also, although to a lesser extent, the effect of CGT on the stock return volatility and on the dividend policy.

Fig. 12: Impact of CGT on Rate of Return (Sub-Themes)

3.6 General observations

For completeness, persons who have authored more than one of the analysed articles are presented in Figure 13. While most of these authors tended to publish in different ranking journals, two of the authors have only published (on CGT related matters) in A-rated journals.

Fig. 13: Authors with More than One Article



4. CONCLUSION

This article explored the rich diversity of the CGT literature published in prestige (A*, A-rated) and other rated (B, C and non-rated) journals from 2012 to 2016 so as to enhance the understanding of the most recent CGT literature in academic journals of different ranking status.

A systematic review methodology – specifically a systematised review strategy – was followed where selected *a priori* determinants were used as an analytical foundation to assess the quality of the publications and to synthesise specific themes of the selected articles. These articles were analysed in detail according to the following determinants: year of publication, country, the research design, method and analysis technique employed and the theme/s of the article.

CGT research has taken place over the last five years, with a spurt from 2012 but the momentum seemed to diminish after 2013 – with a swell again in 2016. An increase in high quality (A*-rated) CGT research in 2016 perhaps signifies that there are still various elements of the CGT regime that are unclear or require more attention from scholars and governments alike.

The CGT regimes in the US and Australia have dominated the CGT research space, with most A*-rated articles considering the US CGT determinants. The experimental research design, simulation (model building) method and regression analyses are the research designs, methods and analysis techniques used predominantly by researchers publishing in the different journals. Regression analysis techniques were predominantly used in A* and A-rated journals, whereas a thematic analysis was the most widely adopted technique in non-rated journals.

Five broad themes emerged from the literature and these include (in order of dominance): (i) the impact of CGT on trading behaviour; (ii) the structure, design and/or reform of CGT; (iii) the impact of CGT on the rate of return for an investor; (iv) court case analyses, and (v) the impact of CGT on asset values. In relation to CGT's impact on trading behaviour, the lock-in effect and tax changes (for instance, tax rate changes, reforms or timing of the changes) are the main areas that have received attention by various researchers and journals.

As with most research, this study has limitations. First, the restricted access to (and search of) scientific databases meant that not all potential CGT articles and publications were included in this initial study, though the authors plan to expand this search in future. Secondly, only journal articles (not other publications) containing CGT in the title were selected, implying that CGT issues contained in reports or books, for instance, or within an article dealing with other issues and not CGT issues alone, fell outside the scope of this analysis.⁸ Thirdly, the period covered by this initial review was only from 2012 to 2016 and therefore the results do not provide a more historic perspective of the CGT literature. Lastly, the quality of the journal was assessed using the ABDC journal quality list. Although the ABDC journal quality list is an expert-based ranking list that is widely accepted amongst academics as a reliable indicator of quality, other journal quality rankings lists do exist and could be considered in the future as alternatives to the list adopted in this study.

Despite the limitations identified, this article provides an initial starting point for future CGT research and, to an extent, also provides an initial framework that can be used for a consistent evaluation of CGT literature. It also highlights certain characteristics of publications that are more prevalent the higher the journal is ranked. This is relevant to researchers given the growing importance of journal rankings in academic performance management. The interdisciplinary nature of CGT research is showcased in this article and this will hopefully provide valuable information for future researchers and other policy-makers in the broader tax environment wishing to explore the capital gains tax phenomenon as a research topic.

⁸ Burian and Brčák (2016) and Hubbard (2015) are examples of publications that were excluded from the analysis.

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APPENDIX A: LIST OF ARTICLES ANALYSED

Title	Journal name	Year Published	Author(s)
A look inside the black box of capital gains taxation.	<i>Journal of Financial Service Professionals</i>	2012	Hulse, D S
An argument for either excluding death as a capital gains tax event or abolishing estate duty.	<i>South African Journal of Accounting Research</i>	2012	Roeleveld, J
An evaluation of the contribution of Justice Hill to the provisions for the taxing of capital gains in Australia.	<i>Australian Tax Forum</i>	2013	Wallace, M, Hart, G & Evans, C
Capital gains jabberwocky: capital gains, intangible property, and tax.	<i>Hofstra Law Review</i>	2012	Black, S T
Capital gains tax in Pakistan: illicit financial flows through presidential order?	<i>Contemporary Legal and Economic Issues</i>	2013	Lorenz, C
Capital gains tax in South Africa: perceptions of fairness?	<i>South African Journal of Economic and Management Sciences</i>	2014	Maroun, W, Turner, M & Coldwell, D
Capital gains tax, managed funds and the value of dividends: the case of New Zealand.	<i>The British Accounting Review</i>	2013	Hodgkinson, L & Partington, G
Capital gains tax, supply-driven trading and ownership structure: direct evidence of the lock-in effect.	<i>Accounting & Finance</i>	2013	Hanlon, D & Pinder, S
Capital gains taxation and equity returns: the case of mutual savings banks.	<i>Journal of Business Finance & Accounting</i>	2012	Kelly, M A, Wu, X & Chambers, D R
Capital gains taxes and expected rates of return.	<i>The Accounting Review</i>	2012	Sikes, S A & Verrecchia, R E
Capital gains taxes and stock return volatility.	<i>The Journal of the American Taxation Association</i>	2013	Dai, Z, Shackelford, D A & Zhang, H H

Title	Journal name	Year Published	Author(s)
Capital gains taxes and the market response to public announcements in an indexation-based tax regime.	<i>Journal of Contemporary Accounting & Economics</i>	2012	Clinch, G & Odat, M
Capital tax reform and the real economy: the effects of the 2003 dividend tax cut.	<i>American Economic Review</i>	2015	Yagan, D
Clash of the deeming provisions: pre-CGT concessions, tax consolidation and policy in the federal court	<i>Australian Tax Forum</i>	2016	Barros, C, Teo, E & Hinchliffe, S
Cross-base tax elasticity of capital gains.	<i>Applied Economics</i>	2016	Jacob, M
Data choice in capital gains realisation response studies - a review.	<i>Journal of Australasian Tax Teachers Association</i>	2014	Minas, J
Depreciation-related capital gains, differential tax rates, and the market value of real estate investment trusts.	<i>Journal of Real Estate Finance and Economics</i>	2016	French, D W & Price, S M
Dividend and capital gains taxation under incomplete markets.	<i>Journal of Monetary Economics</i>	2012	Anagnostopoulos, A, Cárceles-Poveda, E & Lin, D
Do tax sensitive investors liquidate appreciated shares after a capital gains tax rate reduction?	<i>National Tax Journal</i>	2012	Chyz, J A & Li, O Z
Fundamental accrued capital gains and the measurement of top incomes: an application to Chile.	<i>The Journal of Economic Inequality</i>	2016	López, R E, Figueroa, E & Gutiérrez, P
Heuristic portfolio trading rules with capital gain taxes.	<i>Journal of Financial Economics</i>	2016	Fischer, M & Gallmeyer, M F
Modeling capital gains taxes for trading strategies of infinite variation.	<i>Stochastic Analysis and Applications</i>	2015	Kühn, C & Ulbricht, B

Title	Journal name	Year Published	Author(s)
New evidence on the tax elasticity of capital gains.	<i>National Tax Journal</i>	2015	Dowd, T, McClelland, R & Muthitacharoen, A
On the role of intangible information and capital gains taxes in long-term return reversals.	<i>Financial Management</i>	2013	Bhootra, A
Optimal tax timing with asymmetric long-term/short-term capital gains tax.	<i>Review of Financial Studies</i>	2015	Dai, M, Liu H, Yang, C & Zhong, Y
Saving the farm or giving away the farm: a critical analysis of the capital gains tax preferences.	<i>San Diego Law Review</i>	2016	Taite, P C
State power to impose capital gains taxes on nonresidents: a note on S corporations and other pass-through entities.	<i>Journal of Taxation of Investments</i>	2016	Entin, J L
Tax regimes and capital gains realizations.	<i>European Accounting Review</i>	2016	Jacob, M
Taxation of capital gains and lock-in effect in the Spanish dual income tax.	<i>European Journal of Management and Business Economics</i>	2016	Caro, C D & Cebada, E C
Taxes and life cycle capital gains realizations.	<i>Applied Economics Letters</i>	2013	Jacob, M
Taxing capital gains-views from Australia, Canada and the United States.	<i>eJournal of Tax Research</i>	2013	Minas, J & Lim, Y
Taxing personal capital gains in Australia: an alternative way forward.	<i>Australian Tax Forum</i>	2015	Evans, C, Minas, J & Lim, Y
The curious beginnings of the capital gains tax preference.	<i>Fordham Law Review</i>	2016	Mehrotra, A K & Ott, J C
The effect of capital gains taxes on the initial pricing and underpricing of IPOs.	<i>Journal of Accounting and Economics</i>	2016	Li, O Z, Lin, Y & Robinson, J R
The effect of South African dividend and capital gains taxes on share prices and investor expected returns.	<i>Journal of Applied Business Research</i>	2014	Toerien, F & Marcus, M

Title	Journal name	Year Published	Author(s)
The effect of the timing and direction of capital gain tax changes on investment in risky assets.	<i>The Accounting Review</i>	2012	Falsetta, D, Rupert, T J & Wright, A M
The relationship between principles and policy in tax administration: lessons from the United Kingdom capital gains tax regime with particular reference to a proposal for a capital gains tax for New Zealand.	<i>eJournal of Tax Research</i>	2016	James, S & Maples, A
The small business CGT concessions: evidence from the perspective of the tax practitioner.	<i>Revenue Law Journal</i>	2014	Sadiq, K & Marsden, S
Things hidden since the creation of the capital gains tax break.	<i>Political Theology</i>	2013	Dubler, J
“You had me at ‘no capital gains tax on a disposal’”: legal and theoretical aspects of standalone image rights.	<i>Legal Studies</i>	2016	McArdle, D

APPENDIX B: LIST OF JOURNALS

Journal name	<u>A*- rated</u>	<u>A- rated</u>	<u>B- rated</u>	<u>C- rated</u>	<u>Not rated</u>
<i>Accounting & Finance</i>		1			
<i>American Economic Review</i>					1
<i>Applied Economics</i>		1			
<i>Applied Economics Letters</i>			1		
<i>Australian Tax Forum</i>		3			
<i>Contemporary Legal and Economic Issues</i>					1
<i>eJournal of Tax Research</i>		2			
<i>European Accounting Review</i>	1				
<i>European Journal of Management and Business Economics</i>					1
<i>Financial Management</i>		1			
<i>Fordham Law Review</i>					1
<i>Hofstra Law Review</i>					1
<i>Journal of Accounting and Economics</i>			1		
<i>Journal of Applied Business Research</i>					1
<i>Journal of Australasian Tax Teachers Association</i>			1		
<i>Journal of Business Finance & Accounting</i>		1			
<i>Journal of Contemporary Accounting & Economics</i>		1			
<i>Journal of Financial Economics</i>	1				
<i>Journal of Financial Service Professionals</i>					1
<i>Journal of Monetary Economics</i>	1				
<i>Journal of Real Estate Finance and Economics</i>		1			
<i>Journal of Taxation of Investments</i>					1
<i>Legal Studies</i>					1
<i>National Tax Journal</i>		2			
<i>Political Theology</i>					1
<i>Revenue Law Journal</i>			1		
<i>Review of Financial Studies</i>	1				
<i>San Diego Law Review</i>					1
<i>South African Journal of Accounting Research</i>					1
<i>South African Journal of Economic and Management Sciences</i>				1	
<i>Stochastic Analysis and Applications</i>			1		
<i>The Accounting Review</i>	2				
<i>The British Accounting Review</i>		1			
<i>The Journal of Economic Inequality</i>			1		
<i>The Journal of the American Taxation Association</i>		1			
Total	6	15	6	1	12

Tax practitioner judgements and client advocacy: the blurred boundary between capital gains vs. ordinary income

John Hasseldine* and Darius Fatemi**

Abstract

Tax planning often involves ambiguous law, necessitating the exercise of professional judgement. In this article, we review prior scholarly literature on client advocacy of tax practitioners. Tax planning in the US and elsewhere often involves a distinction in whether income is subject to taxable treatment as capital gains, or as ordinary income, under the tax code. As a case example we focus on one particular tax case that has been repeatedly used by US tax accounting researchers (originally based on Cloyd & Spilker, 1999) to show how professionals' judgements and decisions can be affected by the underlying incentives of the client case. We discuss the implications of our findings in relation to the contribution that can be made by behavioural tax researchers to tax policy debates and also link in our findings to wider policy objectives involving regulation of tax preparers and the complexity of tax laws.

Key words: Capital gains, ordinary income, code of conduct, professional judgement, client advocacy

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1. INTRODUCTION

Prior literature, for example Evans and Sandford (1999) and Evans (2000), shows that capital gains tax regimes are complex in their detail and often associated with significant administrative and compliance costs, while not necessarily raising significant tax revenue. This is true for capital gains taxes in Australia and the UK, and likely true elsewhere, and may contribute to the reluctance of some countries to introduce a CGT (e.g., New Zealand) despite calls for its introduction (White, 2017).

Although there are very few (or no) research studies of the costs of operating capital gains tax in the US, it seems a reasonable axiom that the Capital Gains and Losses rules contained in Title 26 US Code, Subchapter P are just as complex as in other countries. For instance, accounting students seeking to work in tax will need to grapple with distinctions between short and long-term gains, issues relating to sales of businesses, capital gains deferrals, like kind exchanges, etc., and keep up-to-date with the frequent changes made to the Code.

A common response when individual taxpayers and small firms face high compliance costs and/or tax complexity is to engage the services of a tax preparer. Extensive prior research (e.g., Christensen, 1992; Stephenson, 2007) shows that some of the common motivations for seeking return preparation and planning services from tax professionals include the desire to file an accurate return, opportunity to save tax, problems with perceived complexity, lack of knowledge, avoidance of audits and penalties etc.

Tax professionals are bound by the ethical code of conduct of the professional association of which they are professional members (e.g., American Institute of Certified Public Accountants (AICPA), 2014), and additionally, contingent on the jurisdiction where they practice, by regulation by the tax agency. While many researchers (e.g., Walpole & Salter, 2014) have discussed specific details of these regimes elsewhere, and there is a continuing saga in the US in terms of regulating preparers, this article does not focus on tax agency registration or regulation. Rather, the focus here is on the role of professionals and how the code of conduct rules placed upon them by their professional associations might impact professionals' judgements and reporting recommendations to their clients.

In Australia, Tran-Nam, Lignier and Evans (2016) use survey evidence to explore practitioners' attitudes to tax law changes affecting tax complexity and compliance costs. Whereas in the US, behavioural tax researchers in accounting tend to utilise experiments that are often grounded in social psychology, and similar to but distinguishable from the experimental economics literature (e.g., Alm, Bloomquist & and McKee, 2017). For example, drawing on mental accounting (Thaler, 1985), a high profile study by Falsetta, Rupert and Wright (2013) demonstrated that the manner in which capital gains tax law changes are implemented affects the amount of investment in a risky asset. Specifically, taxpayers invest more in a risky asset when there is a capital gain tax decrease that is implemented gradually rather than all at once (as individuals prefer several 'small gains' rather than one 'large gain'), notwithstanding that there may be increased complexity associated with this option.

The purpose of this article is to showcase the contribution that behavioural tax experiments can make in tax research. The construct of tax professionals' client advocacy is used as an example (see Jackson & Milliron, 1989), in particular, an experimental case originally developed and used by Cloyd and Spilker (1999), to

showcase how experimental work can help explain the behaviour of taxpayers and tax professionals.

This article is structured as follows. Section 2 defines client advocacy and presents prior research on client advocacy in an accounting setting. Section 3 outlines the case developed by Cloyd and Spilker (1999) where practitioners were asked to judge a case, and consider whether a taxpayer should be a dealer (reporting ordinary taxable income) or an investor (reporting capital gains – taxable at a lower rate) and outlines the contribution of five extensions/replications using this case. In section 4, the article discusses the contribution of such experimental research and how this method can contribute to wider policy issues including tax complexity, tax reform, and tax professionals' judgements and decisions – particularly those involving client advocacy.

2. PRIOR LITERATURE ON CLIENT ADVOCACY

Nickerson (1998, p. 175) states that 'confirmation bias, as the term is typically used in the psychological literature, connotes the seeking or interpreting of evidence in ways that are partial to existing beliefs, expectations, or a hypothesis in hand'. It has been extensively researched in psychology (Klayman, 1995; Oswald & Grosjean, 2004) and prior research in accounting has shown that auditors can be influenced by client preferences (McMillan & White, 1993; Salterio & Koonce, 1997), although it is also influenced by whether the audit client is low-risk or high-risk (Hackenbrack & Nelson, 1996). In a tax setting, Mason and Levy (2001, p. 127) define client advocacy as: '.... a state of mind in which one feels one's primary loyalty belongs to the taxpayer. It is exhibited by a desire to represent the taxpayer zealously within the bounds of the law, and by a desire to be a fighter on behalf of the taxpayer'.

Bobek, Hageman and Hatfield (2010) highlight the 'within the bounds of the law' aspect noting that professionals should be unbiased in their evaluation of evidence and in their reporting recommendations to tax clients, and may even face preparer penalties from the Internal Revenue Service (IRS) under §6694 of the Internal Revenue Code where there is an understatement of a taxpayer's liability by a tax return preparer. Bobek et al. (2010) review prior advocacy research, noting that about half of the prior studies have not measured participants' advocacy attitudes, but rather researchers have experimentally created a treatment effect for advocacy by stating the client's preference. Some studies have however measured advocacy attitude, primarily relying on a scale developed by Mason and Levy (2001) and Levy (1996).

Table 1 reports summarised details from eight prior studies on client advocacy. Results have been mixed in that some studies have found a significant effect for measured advocacy attitude on the respective tax judgements (Johnson, 1993), while others have not (Kadous & Magro, 2001). Of the eight studies, six have been conducted in a tax setting, with two studies using both auditors and tax professionals.

Pinsker, Pennington and Schafer (2009) found that the effect of decision context (tax versus audit) was moderated by the professional's attitude toward advocacy, and that advocacy attitude was significantly lower for the auditors than for the tax accountants, which they attribute to auditor professional scepticism. Pinsker et al. found that advocacy attitude significantly correlated with the final decision, regarding disclosure of a contingent liability, for the auditors but not for the tax professionals. Roberts (2010) posited a tendency toward pro-client decision making in a financial setting, finding that

auditors conform their professional judgements to a client's demand for earnings management when client preferences are explicit.

Table 1: Exemplars of Prior Literature Investigating Client Advocacy in a Tax Setting

Johnson (1993)

Advocacy Scale:	developed 17 questions
Audit / Tax:	Tax
Students / Professionals:	Professionals (mean 3 year experience)
IVs:	½ cases labeled as Favourable (Unfavourable)
DVs:	Net score of weight on Fav less weight on Unfav cases; Strength of advice
Case:	Salary or Dividend
Result:	Higher advocacy increases higher weight on supportive evidence

Cuccia et al. (1995)

Advocacy Scale:	1 question, 1 (pro-client) – 11(pro-government) scale
Audit / Tax:	Tax
Students/ Professionals:	Professionals, mean age 33
IVs:	Verbal standards (More likely than not) vs. numeric standards (55%); Conservative client vs Aggressive but legitimate preference
DVs:	interpretation of standard; assessment of evidence; Recommend income or exclusion
Case:	Income or Exclusions of proceeds from defamation of character lawsuit
Result:	Tax professionals interpret stringent standards more liberally, thus, equally as aggressive as less stringent standards. When verbal standard, they used latitude in words to support aggressive decision; When numerical standards in place, they used latitude in assessing the evidential support.

Cloyd and Spilker (1999)

Advocacy Scale:	None
Students / Professionals:	Professionals (mean 31 months experience)
IVs:	Client implicit pref (Dealer w/loss or Investor w/gain) states as client preference is to save tax
DVs:	Search time / Probability a court will support client preference (%) Recommended treatment as Dealer vs. Investor
Case:	Classify expense or capitalise when lacking authoritative guidance
Result:	Professionals spent more time searching for supporting cases, and this confirmation bias is correlated with probability assessment and rec.

Table 1 (cont): Exemplars of Prior Literature Investigating Client Advocacy in a Tax Setting*Kadous and Magro (2001)*

Advocacy Scale:	Davis & Mason (1994)
Audit / Tax:	Tax
Students / Professionals:	Practitioners (mean 12 years exp.)
IVs:	Practice Risk (high vs. low) Outcome Information [Absent, Present (positive), Present (negative)]
DVs:	Strength of Recommendation for aggressive position
Case:	Used the Accumulated Earnings Tax
Result:	Tax professionals process outcome information difference high vs. low risk clients. Less likely to recommend aggressive return if high practice risk. Advocacy scale included as covariate but did not explain variance so subsequently excluded

Kahle and White (2004)

Advocacy Scale:	None
Audit / Tax:	Tax
Students / Professionals:	Professionals (mean 7 years)
IVs:	Evidence Direction, Client Preference (manipulated)
DVs:	Magnitude of Belief Revision
Case:	Worker classification of contractor vs. employee
Result:	Test of Belief Adjustment Model. More belief revision if supportive of client preference.

Pinsker et al. (2009)

Advocacy Scale:	Revised Mason and Levy [M&L] (2001) to 5 questions for audit or tax
Audit / Tax:	Both
Students / Professionals:	Professionals
IVs:	Professional job as auditor or tax
DVs:	Disclose lawsuit or not; Deduct salary or Not
Case:	Disclose probable or reasonable lawsuit; Salary/dividend (Johnson 1993)
Result:	Auditors more sceptical on tax and audit decisions; Greater correlation of advocacy and DV for auditors but more sceptical so implies conservative decision was more likely to disclose. Means on DV decisions not given. Professional role affects judgement

Bobek et al. (2010)

Advocacy Scale:	Used Mason and Levy [M&L] (2001) 9 question scale
Audit / Tax:	Tax
Students / Professionals:	Professionals
IVs:	Low/High risk clients; Low/High Client importance
DVs:	Probability of IRS approval; Advice to client

Table 1 (cont): Exemplars of Prior Literature Investigating Client Advocacy in a Tax Setting*Bobek et al. (2010) (cont)*

Case:	Hobby Loss
Result:	Client-specific characteristics affect advocacy which affects judgements Decreased advocacy if risky client High-importance client increases weight of evidence

Roberts (2010)

Advocacy Scale:	None
Audit / Tax:	Both
Students / Professionals:	Professionals (AICPA mostly small firms)
IVs:	Audit or tax decision and within-subject 3 risk measures: Probability of 3rd party oversight/Probability of losing client/strong-weak NOI
DVs:	Capitalise or expense for average of 8 cases = Prof Judgement scale
Case:	Classify as expense or capitalise it when lacking authoritative guidance
Result:	No difference in tax and audit judgement and concludes that it is equally biased toward client preference for expensing it on tax return and capitalising it on financial statement.

The studies in Table 1 are exemplars and are not an exhaustive set of prior client advocacy studies in accounting, and the article now focuses on six specific client advocacy studies in a capital gains versus ordinary income tax decision setting.

3. THE DISTINCTION BETWEEN CAPITAL GAINS AND ORDINARY INCOME

This section reports on several studies that have all used a tax case originally developed by Cloyd and Spilker (1999). As originally used, a client taxpayer (Jim Hunt) purchased land which he had intended to sell on, but was unable to. With a zoning change, he subdivided the land into 110 lots, sold six of them, and then sold the remaining 104 lots to a residential builder. The facts of this scenario are described in ‘Client Facts’ in the Appendix.

The case can be set to contain a clear client preference for Investor status (taxing as capital gains), but the facts suggest Dealer status with the land being ‘stock in trade’ (inventory), so any gain is taxed as ordinary income. McClelland (2017) notes that over the period 1954–2014 the incentive to report capital gains instead of taxable income if a gain is made on sale has varied as the difference between maximum marginal income tax rates has either varied widely (or aligned closely) from maximum tax rates on capital gains. Currently, at the federal level, the maximum long-term capital gains tax rate is 20% and the maximum marginal income tax rate for individuals is 37%.

If the underlying land is deemed not to be ‘stock in trade’ (inventory) then the taxpayer is classified as an Investor, and any gain or loss is capital. Over time, and with many precedents, the courts have considered several factors (shown in the Appendix) that contribute to classifying the taxpayers as ‘Investor’ or ‘Dealer’ status, although no one factor is determinative.

In an experimental setting of the case, researchers can adjust the cost (basis) of the land, but without altering any other client facts, and therefore a loss from the land sale can result. Ordinary losses can be deducted in a tax return without limit, but capital losses are limited to \$3,000 per year. Accordingly, if a loss results, then the client taxpayer would prefer to be classed as a Dealer (and not an Investor), a mirror reversal of the preferred status if a gain had been realised.

Cloyd and Spilker (1999) use the Jim Hunt case to report the results of two studies that examine causes and effects of confirmation bias in tax information search. They find that the 66 tax professionals' information searches emphasised cases with conclusions consistent with the client's desired outcome (i.e., positive cases) over cases inconsistent with the client's desired outcome (i.e., negative cases), despite the fact that positive cases were no more similar to the client's facts.

In their study, overall responses showed that 58% perceived the courts would rule Jim Hunt was an investor; however, this was split between the manipulated 'investor' group with a mean of 66% vs. the 'dealer' group, with a mean of 49% (significant at $p < 0.01$). Cloyd and Spilker note (1999, p. 310) that the actual likelihood of a court finding the taxpayer is an investor (or dealer) should not vary by client preference condition as the case's facts were identical between the two groups (except for the original purchase price that was experimentally manipulated).

Before Cloyd and Spilker embarked on their second study, they had a panel of four real estate experts independently evaluate the case facts (a partner, a principal, and two senior managers). The expert panel indicated there was a 13.75% chance of courts concluding the client was an investor. In the second study, Cloyd and Spilker manipulated client preference to be an 'investor'. For the 41 tax professionals who participated, the mean assessment of court support for Investor status was 48%. While this is certainly lower than the manipulated 'investor' group in Study 1 (66%), suggesting they were sensitive to the weaker client facts, 18 of the 39 participants still indicated they would likely recommend investor treatment.

Cloyd and Spilker (1999) has been extended by at least five studies, which are now briefly discussed. Cloyd and Spilker (2000) used a similar case to compare the information search behaviours of law students and accounting students and provide evidence that the nature of academic training influences the magnitude to which student proxies of tax professionals are subject to confirmation bias. They find that law students are less prone to confirmation bias when conducting research to resolve an ambiguous tax issue, and suggest that this has implications for professional education and practice.

Since Cloyd and Spilker's (2000) study comparing law and accounting students, legal scholars have begun to study tax avoidance from a legal perspective, such as Bogenschneider (2016) who suggests tax planners search out tax arrangements with determinate legal outcomes in favour of clients. Field (2017) also notes that legal advisers need to identify their own personal philosophy of tax lawyering, where there is no one 'right' approach.

Barrick, Cloyd and Spilker (2004) examine the effects of confirmation bias from staff-level tax accountants' research on their supervisors' initial assessments and recommendations made during the review process for tax research memoranda. The 55 professionals with supervisory experience read a client scenario in which both accuracy and advocacy objectives could not be met because the client-preferred position had no

‘realistic possibility’ of a successful defence on its merits. Barrick et al. (2004) find that when either a biased or an unbiased memorandum did not meet an accuracy objective, supervisors were more persuaded by memoranda that offered encouragement that their advocacy objective might be met than by those that did not. Their results also showed that supervisors tried to remedy confirmation bias by asking more rework from staff who prepared biased memos, than from staff who prepared unbiased memos.

Kadous, Magro and Spilker (2008) used 63 tax professionals to examine whether high practice risk (i.e., exposure to monetary and non-monetary costs of making inappropriate recommendations) reduces client advocacy effects. They report that when professionals face a client with high (vs. low) practice risk, their participants performed a more balanced search, reducing the indirect impact of client preference on judgements. Specifically, participants’ assessment of the probability of a court finding Investor status was: (1) Dealer-status preferred – 28% (low risk client) vs. 51% (high risk client); (2) Investor-status preferred – 69% (low risk client) vs. 53% (high risk client). Recall that earlier Cloyd and Spilker (1999) reported average means for the Dealer group of 49% vs. 66% for the Investor group. Kadous et al. (2008) thus replicate Cloyd and Spilker’s client advocacy results for low risk clients, but their findings demonstrate that high practice risk can serve as a boundary condition on confirmation bias and on client preference effects.

Cloyd, Spilker and Wood (2012) is similar to Barrick et al. (2004) but they focus on whether staff accountants’ confirmation bias in information search is influenced by their supervisor’s initial belief concerning whether the client-preferred tax position can or cannot be supported. Using 83 experienced tax professionals they experimentally manipulated the client’s preferred tax position and the supervisor’s initial belief in a 2×2 between-subjects design and find that confirmation bias is positively associated with subordinates’ assessments of the evidential support for the client-preferred position and that evidential support assessments are positively associated with the strength of recommendations for the client-preferred position.

Spilker et al. (2016) compare the client advocacy attitudes of US tax professionals who perform US tax compliance work with Indian tax professionals who perform US tax compliance work offshore. They find that experienced US tax professionals have stronger client advocacy attitudes than experienced Indian tax professionals, although there was no significant difference between inexperienced US and Indian tax professionals. In further comparisons, they show that client advocacy attitudes of experienced US tax professionals are stronger than those of inexperienced US tax professionals, whereas the client advocacy attitudes of experienced Indian tax professionals were not different from those of inexperienced Indian tax professionals. Spilker et al. (2016) report significant correlations between the client advocacy attitudes of experienced US tax professionals and their recommendations of the client-preferred position, whereas this link was insignificant for experienced Indian tax professionals.

In sum, the research studies relying on the Jim Hunt case have a collective significance. The research cited in this section has largely held the facts as shown in the Appendix constant, and as extensions have been published, more insight into client advocacy effects has been obtained. For instance, initial work showed the tendency of tax professionals to act as client advocates, possibly to the point of being inappropriately aggressive, given Cloyd and Spilker’s (1999) expert panel indicating the case was conservative and only indicating a 14% likelihood of the facts supporting an Investor status finding by a court. More recent work suggests that the inherent practice risk

associated with a specific client can mitigate client advocacy measures. Finally, there is also some support that biased assessments given by either a subordinate (e.g., a staff accountant) or a supervisor may influence client advocacy measures such as recommended treatment as a dealer or investor, and assessments of the likelihood that a court will support a finding of Investor status.

4. DISCUSSION AND CONCLUDING REMARKS

Tax practitioners' judgements and decisions have been extensively researched in the US (for an early comprehensive review, see Roberts, 1998). A bias toward client advocacy on the part of professional accountants was demonstrated almost three decades ago by Ayres, Jackson and Hite (1989), although since then actual findings have been mixed (Bobek et al., 2010). This article continues to explore the tension created between professionals' responsibility to act as a client advocate together with their responsibility for accuracy (i.e., acting 'within the bounds of the law').

Cloyd and Spilker (1999) rely on the disparate tax treatment of land sales as either ordinary or as capital gains, under the US tax code. In their 'Jim Hunt' tax case, treatment groups were experimentally manipulated (by adjusting the basis of the land in the case) to have a clear client preference, even when the facts of the case and court precedents suggested a particular outcome, and hence recommended treatment. Following on from Cloyd and Spilker (1999), a further five studies show in aggregate that this client advocacy bias is persistent across time and samples, and applicable to both professionals at the staff accountant level and those in supervisory positions. The bias does, however, seem to be moderated by the practice risk associated with the particular client.

Understanding the causes of a tax professional's bias of client advocacy can be attributed to specific individual attributes of both the client and the professional, as well as situational environmental characteristics (Roberts, 1998). Fogarty and Jones (2014) interviewed 29 tax professionals, who essentially confirm that tax work is professional practice within an ethical environment. Yet, individual and organisational incentives (including the continuation of client fee revenues, firm reputation, satisfying partners' expectations and maintaining professional ethical standards) are always in the mind of tax professionals (Suddaby, Gendron & Lam, 2009).

Several recent papers such as Fogarty and Jones (2014), Mulligan and Oats (2016) and Suddaby et al. (2009) provide a 'big picture' approach to 'tax practice at the coalface'. Such research on tax planning links to the growing interest in tax avoidance throughout the world, particularly how it interfaces with individuals' decisions, society and morality (Hashimzade & Epifantseva, 2017).

This article highlights studies in client advocacy that use an experimental design that allows researchers to use a controlled environment to explore cause and effect, and to extend and replicate prior work over time, similar to the concluding remarks of Falsetta et al. (2013) in relation to capital gains tax policy research. Of course, using experimental approaches to study client advocacy effects especially using the same experimental scenario (e.g., the Jim Hunt case) is obviously constrained to the one jurisdiction (i.e., the US for this article), although the classification of real estate gains as ordinary income or as capital is a common issue over many jurisdictions.

Finally, at a broad level, a client advocacy bias is one feature that policy-makers and tax administrations in general, may wish to take into account when considering the regulation of the tax profession. The strategic approach of the IRS to tax agents has been highlighted as a problem by the US National Taxpayer Advocate in prior annual reports, and the IRS currently relies heavily on tax preparers, with the possible creation of a ‘pay to play’ system of personalised tax advice (National Taxpayer Advocate, 2016). Apart from the US (Soled & Thomas, 2017), the regulation of tax preparers has also been subject to recent change in other countries, notably Australia (Walpole & Salter, 2014).

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APPENDIX: TAX REPORTING CASE BASED ON CLOYD AND SPILKER (1999)**A TAX REPORTING DECISION**

Assume a client, Jim Hunt, asks you whether he must classify some land sales as ordinary or capital. He believes it is an ambiguous tax issue and has asked for your opinion on how it should be reported. Once you have read the scenario, please respond to the follow-up questions regarding your beliefs.

Jim Hunt is the CEO of Delta Electronics, Inc., an important corporate client for whom we have done audit and tax work for many years. You are in the process of preparing Jim's current income tax return and need to determine whether a \$500,000 gain he realized on sales of real estate should be treated as ordinary or capital. I.R.C. Section 1221 defines a "capital asset" by exception. The relevant exception in this case is provided in Section 1221(1), which provides that "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" is NOT a capital asset.

If Jim's real estate is considered a Section 1221(1) asset (i.e., Jim is viewed as a "dealer"), then the gain will be treated as ordinary. In contrast, if the property is not considered a Section 1221(1) asset (i.e., Jim is viewed as an "investor"), then the gain will be treated as a long-term capital gain. Obviously, Jim would prefer to be treated as an investor with respect to this property so that his gain will be taxed at the lower, alternative rate for long-term capital gains. Jim's marginal tax rate on ordinary income is in the highest bracket, approximately 40%.

Summary of Factors

Factors considered by the courts as indicative of dealer vs. investor status are summarized below. Courts have stressed that no one factor is determinative and that each case must be considered on its own facts. Moreover, these factors have not always been applied on a consistent basis.

Remember that whether an asset is considered a Section 1221(1) asset affects the character of the taxpayer's income or loss as follows:

Section 1221(1) asset: → Dealer → Ordinary Income or Loss

NOT Section 1221 (1) asset: → Investor → Capital Gain or Loss

NUMBER AND FREQUENCY OF SALES. Generally, the greater the number of sales, the more frequent the sales, and the more continuity in sales activities, the greater the likelihood that the taxpayer will be considered a dealer.

DEVELOPMENT ACTIVITIES. Generally, the greater the development activities, the more likely the taxpayer will be considered a dealer.

SALES ACTIVITIES. Generally, the more the taxpayer advertises, solicits customers, lists the property and otherwise promotes the sale of the property, the more likely the taxpayer will be considered a dealer.

PURPOSE OF ACQUISITION. Generally, the purpose for which the property was originally acquired AND the purpose for which the property was held at the time of its disposition are important in deciding whether the taxpayer is a dealer or investor.

Please turn the page now to continue reading

Client Facts: On June 1, 2009, Jim Hunt purchased 40 acres of undeveloped land for \$1.3 million. At the time, Jim was confident that the land would appreciate in value due to the planned construction of a regional shopping mall nearby. The land was already zoned for “retail/commercial” use and he hoped to sell the land in a single transaction after construction on the shopping mall began. Unfortunately, plans for the shopping mall fell through in early 2010, and Jim was unable to find a buyer for his property. He began placing advertisements in the local paper once a month, and he put on the property a “for sale” sign that was visible from the highway. Despite Jim’s sales efforts, he was unable to locate a buyer.

In June 2012, Jim decided that the property would be much more marketable if he subdivided the land into individual lots for residential development. Jim solicited the help of a friend (a real estate developer), part time, to assist him in the process of developing and selling the land, to be referred to as “Mountain View Estates.” Jim hired an engineer to plat the property into 110 individual lots and to determine the location of streets, etc. Jim submitted the engineer’s drawings to the City Planning Board along with his application to have the property’s zoning changed to “single family residential.” The zoning change was approved in September 2012. Jim incurred engineering and legal costs of \$30,000 in this process.

In October 2012, Jim hired a contractor to build the necessary streets, curbs and drainage systems, and to connect the property to the city’s utility systems (e.g., water, sewer, and electricity). This development was completed by June 2013 at a total cost of \$780,000.

Between August and October 2013, Jim sold six developed lots from the Mountain View Estates development for a total of \$150,000. In October, a residential builder offered \$2.5 million for the remaining 104 lots. Jim accepted the offer and ceased other sales activities. The sale was completed on November 1, 2013. After accounting for the property improvements and selling expenses, Jim had an overall gain of \$500,000 computed as follows:

Bulk sale proceeds	\$2,500,000	
Sale of six individual lots	150,000	
Less: Selling expenses	(10,000)	
Compensation for friend	<u>(30,000)</u>	
Total amount realized		\$2,610,000
Original basis	\$1,300,000	
Engineering & Legal Costs	30,000	
Development costs	<u>780,000</u>	
Adjusted basis		<u>\$2,110,000</u>
Realized gain		<u>\$ 500,000</u>

In January 2013, having become knowledgeable about residential land development, Jim decided to purchase and subdivide an additional 60 acres adjacent to Mountain View Estates. An engineer was hired to plat the land into 200 residential lots, known as “Mountain View Estates, Phase II” and the plans were approved by the City Planning Board in April 2013. In July 2013, Jim hired the same contractor who did the development work on Mountain View Estates to do similar work on Mountain View Estates, Phase II. The contractor constructed the streets, curbs and drainage systems for the Phase II development. The contractor also connected the Phase II lots to the city’s utility system. Although development of the Phase II lots was nearly complete by December 2013, none of the Phase II lots had been sold as of the end of 2013. Jim plans to begin selling the Phase II lots to individual buyers during 2014.

Reforming Australia's 50 per cent capital gains tax discount incrementally

Brett Freudenberg* and John Minas**

Abstract

This article considers concerns about Australia's capital gains tax (CGT) discount (providing generally for a 50 per cent discount on taxation of gains of resident taxpayers other than companies from disposal of assets held for more than 12 months) related to fiscal adequacy, and horizontal and vertical equity. We argue that, based on these concerns, there is a case for reform of the CGT discount. In considering reforms, there are two broad choices available to policy-makers. The CGT discount could be reformed by way of an incremental approach or, in the alternative, through its complete removal and replacement with new provisions. In this article, we argue that it may be more pragmatic to adopt the former approach. In the case of the CGT discount, an appropriate incremental reform would be to change the rate of the discount and introduce a non-cumulative annual CGT discount cap. Although there are arguments for abolishing the CGT discount and reverting to the taxation of capital gains at full marginal tax rates, this may be difficult to achieve in practice. The incremental approach has been used successfully in previous tax reforms in Australia and this type of reform does not preclude policy-makers from pursuing the taxation of capital gains at marginal tax rates as a longer-term policy goal. We argue that well-executed incremental reform can help avoid grandfathering of the former provisions and, in turn, avoid the complexity associated with such a rule.

Key words: capital gains tax, CGT, discount, tax reform, Australia

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1. INTRODUCTION

This article considers some of the concerns raised about the 50 per cent CGT discount in public discussion to date and the two possible broad approaches to its reform that have been identified in that discussion. Although there is a case for one of these approaches, namely abolishing the CGT discount, there is an argument that a more politically viable path to reform is by way of the other of the reform paths, involving an incremental approach.

The CGT discount has provided opportunities for tax sheltering and it has compromised tax system integrity,¹ horizontal equity, and vertical equity. Notwithstanding the problems with the CGT discount, this article sets out an argument for reducing the rate of the discount rather than abolishing it. It is argued that such incremental change to the CGT discount may constitute a pragmatic approach to reform. Although there is a case for a comprehensive approach to taxing capital gains, under which capital gains are taxed at full marginal rates, achieving this in the short term may be impeded by political considerations. In addition, if the CGT discount were abolished, policy-makers may decide to enact 'grandfathering' provisions to apply to assets taxpayers had acquired before the enactment of the law change. Australia's previous experience with grandfathering and CGT indicates that it increases tax system complexity.

The arguments made in the article to reform the CGT discount incrementally are not an endorsement of the CGT discount. Rather, they reflect the need for immediate incremental reform with the ultimate policy objective being the abolition of the CGT discount. The proposed reform can thus be characterised as a 'second best' policy recommendation.

After this introduction, section 2 of this article sets out some of the concerns about the CGT discount. In section 3 the potential problems related to the complete removal and replacement of the CGT discount are critically analysed and the alternatives considered. In section 4 consideration is given to the ways in which the CGT discount can be reformed to address many of the concerns raised. Conclusions and recommendations are set out in section 5.

2. CONCERNS

Specific concerns about the 50 per cent CGT discount include that it has a tax revenue cost, and that it compromises vertical equity, horizontal equity and tax system neutrality. Arguments for the CGT discount to ensure that inflationary gains are not taxed are unconvincing, given the imprecision of the discount as a proxy for inflation. The CGT discount compromises tax system integrity by creating an incentive for taxpayers to receive most of their income in the form of capital gains and, where possible, to re-characterise income receipts as capital gains. Each of these concerns is now discussed in turn.

2.1 Cost to tax revenue

The CGT discount is one of the most significant tax expenditures for the Australian government. For the 2015-16 tax year, the cost of the CGT discount was estimated to

¹ John Daley, Danielle Wood and Hugh Parsonage, *Hot Property: Negative Gearing and Capital Gains Tax Reform* (Grattan Institute, 2016).

have been AUD 6.2 billion.² It follows that the cumulative revenue cost over the nearly two decades that the CGT discount has been in operation is sizable.

The Ralph Review (which recommended the introduction of the CGT discount) predicted that there would be a revenue positive or revenue neutral effect of the CGT reform package that was enacted in 1999–2000.³ This prediction took into account tax revenue savings due to the ‘freezing’ of indexation of the cost base and the removal of five-year averaging.⁴ The Ralph Review prediction was also based on assumptions about taxpayers increasing the amount of capital gains realised following the enactment of the discount. Notwithstanding that there is likely to be an increase in capital gains realisations following a tax rate reduction (or the enactment of the CGT discount), this does not guarantee an increase in tax revenue. Assuming there is no behavioural response to a CGT rate reduction, there will be a static revenue loss. There will only be a revenue increase if the realisations response is large enough in magnitude to compensate for the static loss.

In 1999 when the enactment of the CGT discount was considered, there was no empirical evidence to support the view that it would necessarily lead to an increase in revenue.⁵ Moreover, a review of the literature from the United States would have cautioned policy-makers against predictions of a capital gains realisations response large enough in magnitude to increase CGT revenue following the enactment of the CGT discount. Recent empirical estimates of the capital gains realisations response imply that the 50 per cent CGT discount for personal taxpayers in Australia is likely to have been a revenue-losing policy.⁶

2.2 Equity

Concerns have been raised about the inequity of the CGT discount. The equity concerns relate to the established ‘good’ tax system characteristics of vertical equity and horizontal equity, as well as the more recent notion of ‘age equity’.⁷ The remainder of this section considers the three types of equity.

2.2.1 Vertical equity

Vertical equity requires that taxpayers with a greater ability to pay tax should pay more tax.⁸ A specific feature of Australia's tax system that is designed to achieve vertical

² Ibid 36.

³ Review of Business Taxation (John Ralph, chair), *Review of Business Taxation: A Tax System Redesigned: More Certain, Equitable and Durable, Final Report of the Review of Business Taxation* (July 1999) (Ralph Review). Specifically, according to the Review, 698, Table 24.1, the projected revenue impact of the CGT reforms was an estimated net revenue gain of AUD 450 million for the years 2000–01 to 2004–05 inclusive.

⁴ Ralph Review, above n 3, 725, Table 24.7.

⁵ This, in part, relates to the fact that estimates of the realisations response could not be prepared in the absence of previous changes in the CGT rate.

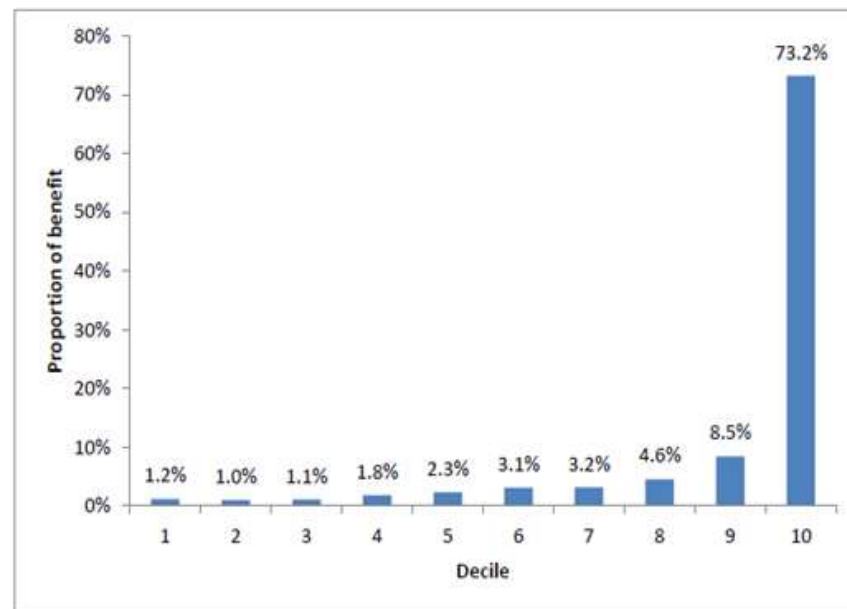
⁶ John Minas, Youngdeok Lim and Chris Evans, ‘The Impact of Tax Rate Changes on Capital Gains Realisations: Evidence from Australia’, (2018) 33(4) *Australian Tax Forum* 635.

⁷ Although there is an absence of literature on age equity, the data discussed in this section of the article suggest that this concept may attract increased attention. To the extent that tax preferences are skewed towards a particular age demographic, it can be argued that the tax system is inequitable in terms of taxpayer age. This type of inequity is not the result of tax policies that are only available to particular age groups.

⁸ Leonard E Burman, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed* (Brookings Institution Press, 1999) 3.

equity is the progressive marginal tax rate scale for resident individuals.⁹ Notwithstanding these progressive tax rate scales, vertical equity is compromised by the operation of the CGT discount. Specifically, data on the net capital gains of individual taxpayers in Australia indicate that most of the benefit of the CGT discount is skewed towards high income taxpayers. Specifically, nearly three-quarters of the benefit of the CGT discount accrues to the top 10 per cent of taxpayers by household income.¹⁰ The top 20 per cent of household incomes received 82 per cent of the CGT discount, whereas only 14 per cent of the CGT discount was accessed by the bottom 70 per cent of household incomes: Figure 1.¹¹

Fig. 1: Distribution of CGT Discount by Household Income



Source: NATSEM, ATO (2014) *Taxation Statistics 2011-12*, updated to 2014-15

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 CGT rate lower than the tax rate on other forms of income 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 when they realise capital gains. Such inequity can lead to an increasing

⁹ The Australian personal tax system for resident taxpayers has a tax-free threshold (a tax rate of zero) for those with a taxable income up to \$18,200. The highest tax rate of 45 per cent applies to taxable income amounts over \$180,000. Tax rates of 19 per cent, 32.5 per cent and 37 per cent apply to various levels of taxable incomes in between these lowest and highest rate brackets. In addition to these statutory tax rates, taxpayers may be liable for levies and surcharges which increase overall tax liability.

¹⁰ 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, citing estimates by the National Centre for Social and Economic Modelling (NATSEM): 73.2 per cent to the top ten per cent.

¹¹ Ibid: NATSEM estimates.

concentration of wealth, which has been described by Thomas Piketty as a marker of an 'endless inegalitarian spiral'.¹²

It is also arguable that vertical inequity is heightened due to capital gains generally only being taxed on realisation. Specifically, a taxpayer's wealth – and their ability to pay tax – increases where the value of their assets increases.¹³

2.2.2 Horizontal equity

Horizontal equity refers to the notion that taxpayers with the same economic wealth should be required to pay the same amount of tax.¹⁴ The CGT discount breaches horizontal equity, given that it provides a tax preference for most taxable capital gains.¹⁵ By contrast, other types of income do not receive this type of preferential tax treatment. Horizontal equity is important to a self-assessment tax system, since perceptions of unfairness can have an adverse effect on enforceability.¹⁶ The horizontal inequity caused by the CGT discount relates to taxpayers with the same level of income incurring different tax liabilities because of their income including different proportions of discount capital gains.

The disparity between the preferential tax treatment of capital gains and the non-preferential treatment of other income is accentuated by the time value of money, given that capital gains are taxed on a realisation basis, whereas other income, such as wages, are taxed in the year they are derived.¹⁷ Under a pure comprehensive income tax, capital gains would be taxed as they accrue and accrued capital losses could be used to offset all types of income, without restriction.

Notwithstanding the realisation basis of taxing capital gains, the CGT discount breaches horizontal equity, given that taxpayers with discount capital gains face a lower effective tax rate than taxpayers without capital gains.

2.2.3 Age equity

In addition to the established concepts of vertical and horizontal equity, another way to conceptualise equity in the tax system is according to the tax treatment of taxpayers in various age groups. This characterisation has gained attention recently, given that many previously available concessions in the tax system have been slowly eroded due to budgetary concerns. In some cases, the removal of a tax concession is accompanied by grandfathering provisions that can entrench the tax advantages of the repealed law. To the extent that older taxpayers have had increased opportunities to benefit from

¹² Thomas Piketty, *Capital in the Twenty-First Century* (Harvard University Press, 2013).

¹³ Although some may argue that taxpayers with unrealised gains have a lesser ability to pay tax due to liquidity problems, it is clear from a review of the CGT events in the *Income Tax Assessment Act 1997* (Cth) that CGT liability can result from certain events that do not increase the taxpayer's liquidity.

¹⁴ Claudio M Radaelli, 'Taxation Research as Political Science Research' in Margaret Lamb et al, *Taxation: An Interdisciplinary Approach to Research* (Oxford University Press, 2005) 85.

¹⁵ Based on Australian Taxation Office, *Taxation Statistics 2014-15*, Table 1 Selected capital gains tax schedule items by entity, 2014-15 income year. It is estimated that discount capital gains were approximately 95 per cent of the capital gains of personal taxpayers in that year.

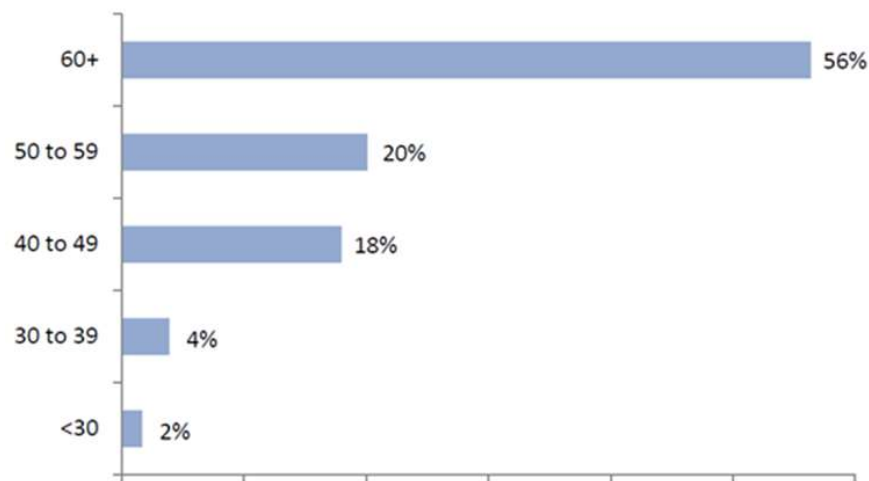
¹⁶ Willard H. Pederick, 'Fair and Square Taxation for Australia' (1984) 19(6) *Taxation in Australia* 575.

¹⁷ This is especially the case when one considers that under the PAYG-Withholding system, employers are required withhold income tax from wage and salary payments to employees.

longstanding tax preferences, the subsequent repeal and grandfathering of these preferences is, arguably, biased towards older taxpayers.

As indicated in Figure 2, individual taxpayers in the age group of 60 years and above benefit most from the CGT discount compared to taxpayers in younger age groups.¹⁸ The higher proportion of capital gains realised by older taxpayers may reflect higher levels of accrued capital gains that have accumulated over a longer period of time compared to the younger age groups. Another factor that may influence the skewed distribution of capital gains by taxpayer age is the greater propensity to realise capital gains when income is lower.¹⁹

Fig. 2: CGT Discount by Age Group



Source: The Australia Institute, 'Briefing Note: Tax Concessions by Age' (15 February 2016) 2.

2.3 Inefficient investment decisions

Another concern about the CGT discount relates to the notion of tax neutrality. The potential for the tax system to unintentionally distort taxpayers' investment decisions is undesirable. Tax neutrality is an important principle of tax system design that requires neutrality in relation to taxpayer investment or consumption choices.²⁰ In instances of significant neutrality breaches, the tax system could impede or reduce the productive capacity of an economy.

Modern tax systems are far removed from the ideal models advocated in the public finance literature. One of the reasons for this is that governments may intentionally breach one of the tax policy criteria in the belief it will achieve desirable policy goals.

¹⁸ The Australia Institute, 'Briefing Note: Tax Concessions by Age' (15 February 2016) 2.

¹⁹ Typically, the incomes of some taxpayers in the 60 and over age group would be lower due their being in retirement.

²⁰ Some have argued that there is more than one concept of tax neutrality. One of the more prominent examples of an alternative definition is that tax neutrality is a description of tax provisions that conform to an ideal tax system. See Douglas A Khan, 'The Two Faces of Tax Neutrality: Do They Interact or Are They Mutually Exclusive?' (1990) 18(1) *Northern Kentucky Law Review* 1.

For example, tax neutrality can be breached by the introduction of tax concessions for expenditure on research and development to encourage greater expenditure. Such tax concessions may, however, provide incentives for aggressive tax planning.

Tax neutrality requires a tax to be judged according to the extent to which it influences the allocation of resources.²¹ Taxes that do not interfere with the market allocation of resources are referred to as neutral.²²

Increasingly, governments have acknowledged the importance of tax neutrality,²³ in some cases at the expense of equity.²⁴ Tax neutrality was discussed in the Asprey Report in Australia in the mid-1970s²⁵ and, more recently, its importance was further emphasised by the Ralph Committee.²⁶ The Henry Review has also reiterated the adverse effect that a departure from neutrality may have, noting that it 'sets up the potential for inefficient outcomes that can affect overall business productivity'.²⁷

An example of a potential effect of the tax system on neutrality is the case of the Australian housing market. Some commentators have argued that there has been an overinvestment in housing, owing in part to tax preferences such as the CGT discount. Taxpayers contemplating investing in real property are likely to factor into their decisions the benefits of concessional CGT treatment, especially when rental yields are relatively low. On this point, an interview study with Australian rental property investors, conducted by Seelig et al, reported that, in most cases, respondents' decision to invest in rental properties was more strongly motivated by the prospect of capital gains rather than by the derivation of rental income.²⁸

A supposed benefit of the CGT discount is that it encourages risk-taking by entrepreneurs, as it increases their after-tax return on selling a successful business.²⁹ Cunningham and Schenk are critical of capital gains preferences as incentives for risk-taking, because the preferences are untargeted and they provide incentives for non-risky CGT assets as well.³⁰ If the CGT discount is meant to encourage entrepreneurial activity,

²¹ Peter A Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems* (IBFD Publications, 1996) 8.

²² Ibid.

²³ Steffen Ganghof, 'Adjusting National Tax Policy to Economic Internationalization: Strategies and Outcomes' in Fritz W Scharpf and Vivien A Schmidt (eds), *Welfare and Work in the Open Economy: Vol II Diverse Responses to Common Challenges in Twelve Countries* (Oxford University Press, 2000) 613; Miranda Stewart, 'The Mechanics of Taxing Entity Distributions: A Comparative Perspective' (paper presented at the Australasian Tax Teachers' Association Conference, Sydney, 1-3 February 2001) 4.

²⁴ Early in the 20th century the focus of tax policy appeared more directed to equitable concerns, with consideration as to whether the tax system operated fairly between taxpayers: Radaelli, above n 14.

²⁵ Taxation Review Committee (Justice Kenneth Asprey, chair), *Full Report* (31 January 1975) (Asprey Review) 16: 'Tax neutrality principle requires that the tax system should be neutral between alternative business or consumption choices; and in this way the impact of tax will not influence individual or business choices by distorting or altering the costs of alternatives'.

²⁶ Ralph Review, above n 3, 105.

²⁷ Australian Treasury, *Australia's Future Tax System: Consultation Paper* (10 December 2008) 153.

²⁸ Daley, Wood and Parsonage, above n 1, 24, citing Tim Seelig et al, *Understanding What Motivates Households to Become and Remain Investors in the Private Rental Market* Australian Housing and Urban Research Institute, 2009), http://www.ahuri.edu.au/publications/download/ahuri_20280_fr. The study explored the motivations of rental property investors through in-depth interviews with 30-40 investors in each of the study states of NSW, Victoria and Queensland.

²⁹ Daley, Wood and Parsonage, above n 1, 8-11.

³⁰ Noël Cunningham and Deborah Schenk, 'The Case for a Capital Gains Preference' (1993) 48(3) *Tax Law Review* 319.

it is a poorly targeted policy. This is notwithstanding that an entrepreneur's decision to invest in a new business would not necessarily be guided by the after-tax return on the event of the eventual sale of their business several years later.

Domar and Musgrave analysed the impact of tax on investor behaviour by reference to 'indifference curves',³¹ and argued that increased risk-taking³² is highly desirable and that 'a high degree of loss deduction is of vital importance'.³³ Stiglitz noted the limitations of the kind of analysis used in the Domar and Musgrave study, and concluded that 'even if preferential treatment of capital gains (encouraged greater risk-taking) effectively, it is not clear that preferential treatment of capital gains is the most desirable way of encouraging risk-taking'.³⁴

If policy-makers sought to increase investment in riskier assets, they could develop a policy measure to replace the CGT discount that is much more targeted towards that objective. This could, for example, be by way of a tax incentive that requires assets to be used in business activities.³⁵

There is little evidence in the literature about a CGT rate preference constituting an appropriate method for encouraging entrepreneurship and venture capital investments, given that it is a broad and untargeted way of encouraging such investments. According to Poterba, 'there is very limited evidence on the extent to which the supply of entrepreneurial activity responds to the relative tax burdens on capital gains and labor income'.³⁶

2.4 Inflation

Prior to the enactment of the CGT discount in the 1999-2000 tax year, Australia provided for the indexation of the cost base of CGT assets held for more than 12 months, to ensure that inflationary gains were excluded from assessment.

While various arguments have been made for the tax system to allow for the indexation of the cost base of CGT assets, the CGT discount is difficult to justify on the basis that it is a means of ensuring that inflationary gains are untaxed. In most instances the CGT discount over-compensates taxpayers for the effects of inflation. This is especially the case for capital gains realised immediately after the 12-month qualifying period.³⁷ Furthermore, deductible interest expense invariably includes an inflation component

³¹ Evsey D Domar and Richard A Musgrave, 'Proportional Income Taxation and Risk-Taking' (1944) 58(3) *Quarterly Journal of Economics* 388, 408.

³² Ibid 391: either by way of an investor reducing their total assets held in cash, or by way of a change from less to more risky investments.

³³ Ibid.

³⁴ Joseph Stiglitz, 'The Effects of Income, Wealth, and Capital Gains on Risk-Taking' (1969) 83(2) *Quarterly Journal of Economics* 263, 283.

³⁵ In comparison, the small business CGT provisions in Division 152 of the *Income Tax Assessment Act 1997* (Cth) are generally only available for 'active assets', being those used in the course of carrying on a business (s 152-40). Passive assets, such as those which are used principally to derive rental income are excluded: s 152-40(4)(e).

³⁶ James M Poterba, 'Capital Gains Tax Policy Toward Entrepreneurship' (1989) 42(3) *National Tax Journal* 375, 384.

³⁷ See John Minas, 'Taxing Personal Capital Gains in Australia – Is The Discount Ready for Reform?' (2011) 6(1) *Journal of the Australasian Tax Teachers Association* 65.

and the deductible amount of interest expense should be reduced if an inflation adjustment is made for the amount of capital gains subject to tax.

The justification for inflation adjustments for capital gains is tenuous, given that other forms of capital income, such as rental and interest income, receive no such inflation adjustment. For example, interest income generally includes compensation for inflation, as well as the real interest return. However, the full interest is assessed,³⁸ meaning the effective marginal tax rate can be much higher.³⁹ Furthermore, the argument that one type of assessable income within the tax system should be taxed on real rather than nominal terms, while others do not receive this treatment, is less than compelling. Since capital gains are taxed on a realisation basis and not as they accrue, the benefits of deferral can offset the impact of inflation. For an asset that has been held for several years prior to disposal, the burden of inflation is considerably less than for income that is taxed annually. The non-indexation of the cost base of capital gains assets appears relatively unimportant compared to the case for annual adjustments to personal income tax brackets for inflation. Notwithstanding that the Australian tax system currently lacks a system of annual indexation of personal income tax brackets, there was a time when this had a strong negative impact on vertical equity. On this point, Evans and Krever noted that bracket creep, in combination with increased tax evasion and avoidance in the 1980s contributed to 'extraordinary marginal tax rates imposed on persons with very ordinary weekly earnings'.⁴⁰

2.5 Policy clarity

Part of the reasoning for the introduction of the CGT discount was the view that it could stimulate capital markets and make the Australian regime more internationally competitive.⁴¹ It has also been argued that the CGT discount was intended to reduce the bias that income tax may create against savings and investment,⁴² particularly the bias towards asset retention.⁴³ In theory, a greater liquidity of capital assets could promote more efficient asset management and greater capital mobility.⁴⁴

Nevertheless, the CGT discount creates its own biases in relation to saving and investment. This is because assets for which most of the return is in the form of capital gains are afforded preferential treatment by the tax system in comparison to assets for

³⁸ The full interest return is known as the 'nominal interest rate', which includes the inflation compensation as well as the real interest rate.

³⁹ See the illustration provided in Australia's Future Tax System Review Panel (Dr Ken Henry, chair), *Australia's Future Tax System: Report to the Treasurer* (December 2009) (Henry Review) Pt 2, Vol 1 Detailed Analysis 67.

⁴⁰ Chris Evans and Richard Krever, 'Tax Reviews in Australia: A Short Primer' in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Thomson Reuters, 2009) 3, 7. Evans and Krever also referred to the legislation which, between 1976 and 1979, provided an inflation adjustment for trading stock. At the time it was in operation, these legislative rules in the *Income Tax Assessment Act 1936* Div 3, Subdiv BA were another example of policy which offered an inflation adjustment to one feature of the tax system, while ignoring the effect of inflation on others. For a detailed discussion of Australia's experience with a tax indexation scheme from 1978 to 1981, including the observations from the Asprey Report and Mathews Report, see Chris Terry, *Personal Income Tax Indexation* (Australian Tax Research Foundation, 1983).

⁴¹ Ralph Review, above n 3, 14.

⁴² Daley, Wood and Parsonage, above n 1, 8.

⁴³ Sam Reinhardt and Lee Steel, 'A Brief History of Australia's Tax System' (2006, Winter) *Economic Roundup* 1, 12.

⁴⁴ *Ibid.*

which a larger part of the return is in the form of income. The case for the CGT discount on grounds of capital mobility is somewhat tenuous. This is because non-resident taxpayers are subject to limited assessment on Australian capital gains in comparison to resident taxpayers. Furthermore, the broad effect of Australia's double tax agreements is that many foreign-source capital gains of resident taxpayers would be subject to tax in Australia.

The Ralph Review's forecast of a CGT revenue increase appears to have been the central rationale for the enactment of the CGT discount. However, in the absence of empirical evidence on the capital gains realisations response it cannot be assumed that a reduction in the CGT rate will lead to an increase in revenue from CGT. Nonetheless, at the time the CGT discount was being contemplated in 1999, some of the debate on the relationship between CGT rate reductions and revenue was carried out in overly simplistic terms and in a way that reflected an incomplete understanding from some policy-makers.⁴⁵ If the capital gains realisations response is small or moderate in magnitude it may fail to compensate for the static revenue loss from the lower CGT rate, and the overall effect of the CGT rate cut would be a revenue loss. The most recent estimates of the capital gains realisations response for Australian personal taxpayers, imply that the CGT discount has caused a net loss of tax revenue.⁴⁶

Although calculating a discount capital gain can be simpler than calculating a capital gain under the indexation method, the CGT discount can still increase tax system complexity. Part of the complexity associated with CGT rate preferences arises from legislators seeking to counteract avoidance techniques such as the re-characterisation of income into capital. This may include the enactment of new legislative provisions as a means of bringing CGT events that were not originally contemplated into the tax base.⁴⁷ An example is the legislative complexities encountered in the interaction of the CGT discount provisions of Division 115 of the *Income Tax Assessment Act 1997* with rules relating to specific forms of entity, such as the trust provisions.

Evans established that CGT compliance costs are significant in Australia; this applies in relation to the amount of tax payable, the amount of revenue collected, and the compliance costs of other taxes.⁴⁸ Furthermore, the compliance costs of the CGT regime are a concern to practitioners and there is a serious problem of under-billing for CGT work. In that regard, almost one in two practitioners revealed that they could not recover the full costs of their professional work on CGT from clients, with the estimated average amount of under-billing at 30 per cent.⁴⁹

It is of concern that the policy justification for the CGT discount in 1999 lacked clarity and coherence. Ultimately, it appears that the desired revenue effects were the overarching policy justification. Importantly, it can be argued that the CGT discount has

⁴⁵ For example, Senator Gibson stated, in reference to his understanding of the US experience on the revenue effect of CGT rate changes, that 'when the capital gains tax was increased, revenue went down; when capital gains tax was decreased, revenue went up' (Commonwealth Parliamentary Debates, Senate, 29 November 1999, 10,894). This is not a complete or accurate summary of the effects of CGT rate changes on revenue.

⁴⁶ Minas, Lim and Evans, above n 6.

⁴⁷ It is the case that the number of CGT events contained in the *Income Tax Assessment Act 1997* (Cth) has expanded over time.

⁴⁸ Chris Evans, *Taxing Personal Capital Gains: Operating Cost Implications* (Australian Tax Research Foundation, 2003).

⁴⁹ Ibid.

contributed to negative outcomes that policy-makers at the time did not fully contemplate.

2.6 Re-characterisation of receipts

The CGT discount can provide an incentive for taxpayers to re-characterise revenue receipts as capital receipts. In the US context, Auerbach noted that much of the capital gains realisation activity represents tax arbitrage, characterised by taxpayers realising capital gains and incurring a CGT liability as a way of avoiding other, higher-rate taxes.⁵⁰ The term arbitrage is appropriate for describing this type of activity as these taxpayers may be attempting to re-characterise the legal form of their receipt without changing its economic substance. It is now recognised that a CGT rate cut that increases realisations through an increased arbitrary conversion of income to capital may have the effect of reducing efficiency due to a lowering of tax revenue overall as well as increases in other taxes that are distortionary.⁵¹ This can undermine the integrity of the tax system 'by creating opportunities for artificial transactions to reduce income tax'.⁵²

In conclusion, this section has summarised some of the concerns about the 50 per cent CGT discount. In our view there is a compelling case for reform of this feature of the Australian tax system. The following section considers one broad reform option available, involving complete removal or abolition of the 50 per cent CGT discount and some of the possible difficulties associated with this option.

3. COMPLETE REMOVAL

The case for the taxation of capital gains at full marginal tax rates has been well argued in the literature.⁵³ Notwithstanding the tax policy shortcomings of the CGT discount, there are some arguments against its complete removal from the Australian tax system. These relate to complexity, and impediments to such a reform owing to what can broadly be characterised as the politics of tax reform. These two factors are addressed below.

3.1 Complexity

If the CGT discount was removed and replaced with an alternative way of taxing capital gains this may result in increased complexity, compliance costs and administrative costs. The enactment of new CGT provisions in Australia has typically involved grandfathering of old law.⁵⁴ If a replacement policy is introduced that is accompanied

⁵⁰ Alan J Auerbach, 'Capital Gains Taxation in the United States: Realisations, Revenue, and Rhetoric' (1988) 2 *Brookings Papers on Economic Activity* 595.

⁵¹ Burman, above n 8.

⁵² Daley, Wood and Parsonage, above n 1, 7.

⁵³ See Chris Evans, 'Curing Affluenza: A Critique of Recent Changes to the Taxation of Capital Gains in Australia' (2000) 23(2) *University of New South Wales Law Journal* 299.

⁵⁴ For example, on the enactment of Australia's original CGT provisions with effect from 1985, a decision was made to distinguish between pre-CGT and post-CGT assets. The grandfathered status of pre-CGT assets meant that any capital gain or loss involving such an asset is disregarded. In 1999-2000, the enactment of the CGT discount was accompanied by the retention of the indexation method, albeit with the indexation of cost base 'frozen' at the September 1999 quarter. In each of these instances, the better alternative from a tax policy perspective would have been to enact the new law without grandfathering old law.

by transitional rules or grandfathering of the previous law, compliance costs will typically be higher than in the absence of such rules.⁵⁵

Miller refers to three main types of inherent tax system complexity: technical complexity, compliance complexity and structural complexity.⁵⁶ Excessive complexity increases filing and administrative costs and it has an impact on voluntary compliance,⁵⁷ although several studies have failed to document such a relationship.⁵⁸ In an empirical study in Australia – albeit in the context of personal income tax per se – the level of complexity was found to be directly related to taxpayer compliance costs and thence to taxpayers' commitment to compliance.⁵⁹

Compliance costs⁶⁰ include three major components: monetary costs, time costs, and psychological costs to taxpayers. The private costs to a taxpayer of complying with the tax law can encompass indirect costs, in addition to direct costs, such as collecting documentation; accounting for tax; the fees paid to professional tax advisers; and remitting tax on products.⁶¹ Indirect costs include the value of labour time associated with the completion of tax returns; the investment costs associated with acquiring intellectual capital necessary to enable this work to be done, and psychological costs that many taxpayers experience when trying to comply with tax legislation and regulation.⁶²

According to Sandford, the more complex the tax legislation and regulation, the greater the knowledge gap – or information asymmetry – between legislators and taxpayers, and the greater the costs to the taxpayer of complying with the legislation.⁶³ However the costs of complying with taxation legislation are not limited to taxpayers. Where the tax authorities have a legal duty to monitor and enforce the legislation, the tax authorities themselves face costs of discharging their duties in accordance with the legislation. In a very real sense, these too can be regarded as compliance costs, not the

⁵⁵ Binh Tran-Nam and John Glover, 'Estimating the Transitional Compliance Costs of the GST in Australia: A Case Study Approach' (2002) 17(4) *Australian Tax Forum* 499.

⁵⁶ John A Miller, 'Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation' (1993) 68(1) *Washington Law Review* 1.

⁵⁷ Julie H Collins, Valerie C Milliron, and Daniel R Toy, 'Determinants of Tax Compliance: A Contingency Approach' (1992) 14(2) *Journal of the American Taxation Association* 1; Joachim Vogel, 'Taxation and Public Opinion in Sweden: An Interpretation of Recent Survey Data' (1974) 27(4) *National Tax Journal* 499.

⁵⁸ Thomas M Porcano, 'Correlates of Tax Evasion' (1988) 9(1) *Journal of Economic Psychology* 47; Yankelovich, Skelly and White, Inc, *Taxpayer Attitudes Study: Final Report*, Public Opinion Survey Prepared for the Public Affairs Division, Internal Revenue Service (New York, 1984).

⁵⁹ Margaret McKerchar, *The Impact of Complexity Upon Tax Compliance: A Study of Australian Personal Taxpayers* (Australian Tax Research Foundation, 2003).

⁶⁰ Jeff Pope, 'Estimating and Alleviating the Goods and Services Tax Compliance Cost Burden Upon Small Business' (2001) 11(1) *Revenue Law Journal* 2.

⁶¹ Cedric Sandford, *Hidden Costs of Taxation* (Institute for Fiscal Studies, 1973).

⁶² Ibid; Pierre Cl  roux, 'Small Business and the Cost of Paperwork: The Goods and Services Tax' (1992) 9(4) *Journal of Small Business and Entrepreneurship* 27; Chris Evans, 'Studying the Studies: An Overview of Recent Research into Taxation Operating Costs' (2003) 1(1) *eJournal of Tax Research* 64; Maja Klun, 'Compliance Costs for Personal Income Tax in a Transition Country: The Case of Slovenia' (2004) 25(1) *Fiscal Studies* 93; Jarlath O'Keefe and Peter O'Hare, 'Increased Compliance Costs: VAT and Place of Supply of Services' (2008) (43, Indirect Taxes) *International Tax Review* 27; Luca Barbone, Richard Bird and Jaime V  zquez-Caro, *The Costs of VAT: A Review of the Literature*, Centre for Social and Economic Research (CASE) Network Report No 106/2012 (Warsaw, 2012).

⁶³ Cedric Sandford (ed), *Taxation Compliance Costs: Measurement and Policy* (Fiscal Publications, 1995).

'private' compliance costs of the taxpayer, but the publicly funded compliance costs for the tax regulator.

Some of the complexity associated with the complete removal of the CGT discount would relate to the likelihood of grandfathering rules to accompany the tax law change. If such grandfathering rules were enacted, there would be different tax law applying to different classes of CGT assets which would contribute to inefficiency and increased complexity in the tax system. There are also equity issues when grandfathered tax laws operate concurrently with their replacement provisions.

It appears that changes to the tax system add to complexity for tax advisers.⁶⁴ This can be due to having to learn new rules, as well as consider how they potentially apply to an array of clients. In a study of small business advisors in the US, Australia and New Zealand, a similarity between these jurisdictions was the high ranking of 'frequency of tax law changes' as a factor increasing complexity for advisers.⁶⁵

The probability of increased compliance costs following a complete removal and replacement of the CGT discount is worthy of consideration. One of the main concerns in relation to removing the CGT discount would be the likely retention of grandfathered discount capital gains in the tax system.

3.2 Politics of tax reform

Although policy-makers did not describe the 50 per cent CGT discount as a permanent tax policy change, tax rate preferences, once granted, are difficult for governments to repeal. Since the 50 per cent CGT discount has been in place for longer than the original method of taxing capital gains, the discount has, arguably, become the 'status quo' in tax policy. Australia's recent history has demonstrated that implementing extensive, and meaningful, tax reform can be extremely problematic.⁶⁶ Such difficulties are especially apparent in the case of proposals to reduce or eliminate an existing tax expenditure. It is argued that the complete removal of the CGT discount would be politically difficult, particularly given that many taxpayers have vested interests in maintaining the status quo. It is for this reason that incremental changes, that still result in an improvement to existing tax policy, are more likely to be successful. This can be considered part of the politics of tax reform. On this point, Eccleston observed that:

By its nature taxation requires governments to weigh up economic, ethical and political considerations when determining how to distribute the tax burden across society. Even when these difficult distributional questions have been

⁶⁴ Brett Freudenberg et al, 'A Comparative Analysis of Tax Advisers' Perception of Small Business Tax Law Complexity: United States, Australia and New Zealand' (2012) 27(4) *Australian Tax Forum* 677, 709.

⁶⁵ Ibid 708. The respective rankings of this factor were 4th in the US, 2nd in Australia, and 3rd in New Zealand. The top four factors (in descending order) for each jurisdiction were: US: Partnerships, Estate & Gift Valuation, Tax Deferred Exchanges, and Frequency of Tax Law Changes; Australia: Non-resident trusts, Frequency of Tax Law Changes, Retirement Planning, and Small Business CGT Concessions; New Zealand: Overseas share investments and fair dividend rate method, Associated persons rule – income tax, Frequency of Tax Law Changes, and Land regime.

⁶⁶ For example, most of the tax reforms put forward in the Henry Review have not been adopted by successive governments.

answered, policy makers have to confront a range of technical questions concerning compliance and administration.⁶⁷

Tax reform can be difficult, as it involves motivating stakeholders to move from 'self-interest' to 'public interest',⁶⁸ which has led some to observe that tax policy reform can be the most difficult exercise in a democratic context.⁶⁹ This can be particularly difficult with an institutionally weak state that can be adversely influenced by short-term political pressure.⁷⁰ This has been illustrated at various points in time in Australian history, when tax policy has been 'reactive and opportunistic',⁷¹ to maximise electoral benefit. Eccleston noted that:

In theoretical terms, this preoccupation with short-term political imperatives is typical of what political scientists describe as a pressure pluralist policy environment in which the combination of an institutionally vulnerable state and the absence of a societal consensus for policy change undermines the prospects of comprehensive reform.⁷²

Even when there is a popular government, tax reform can be problematic in the absence of broad community support.⁷³ Particularly in Australia there consistently appears to be partisan opposition to tax reform proposals, which has the tendency to polarise public opinion⁷⁴ and cause key business and community groups to be reluctant to have too close a relationship with either side of politics.⁷⁵

Tran-Nam, Vu and Andrew identified that an incremental approach was the most viable option for personal tax reform in Australia⁷⁶ and this, arguably, applies to reform of the CGT discount. Incremental tax reform may be frustrating where it is characterised by compromises or the enactment of 'second-best policy', but it may be preferable to a drawn-out political process that leads to long delays or the complete abandonment of proposed policies. Although the complete removal of the CGT discount is a worthwhile reform in the longer term, there is a more immediate policy imperative to reduce the rate of the CGT discount.

However, if the CGT discount is to be removed and replaced, then it is critical that the proposed alternatives are critically evaluated, otherwise it is possible that concerns will not be adequately addressed or that there could be unintended consequences.

⁶⁷ Richard Eccleston, *The Thirty Year Problem: The Politics of Australian Tax Reform*, Research Study No 42 (Australian Tax Research Foundation, 2004) 6.

⁶⁸ Ibid 7.

⁶⁹ Claudio M Radaelli, *The Politics of Corporate Taxation in the European Union* (Routledge, 1997).

⁷⁰ Michael M Atkinson and William D Coleman, 'Strong States and Weak States: Sectoral Policy Networks in Advanced Capitalist Economies' (1989) 19(1) *British Journal of Political Science* 47.

⁷¹ Eccleston, above n 67, 68, referring to tax reforms introduced in Australia during the Fraser government years of 1975 to 1983.

⁷² Ibid 68, citing Atkinson and Coleman, above n 70.

⁷³ Ibid 70, referring to the events in 1984 and 1985 in Australia.

⁷⁴ Ibid 141.

⁷⁵ Ibid 19-20.

⁷⁶ Binh Tran-Nam, Linh Vu and Brian Andrew, 'Personal Income Tax Reform in Australia: A Specific Proposal' (2007) 37(2) *Economic Analysis and Policy* 163.

4. ALTERNATIVES TO THE 50 PER CENT CGT DISCOUNT

As discussed in the previous section, an alternative to the CGT discount is the taxation of capital gains at full marginal rates. Taxation of capital gains at full marginal rates may or may not include the indexation of the cost base of CGT assets. Other alternatives include a separate rate schedule for capital gains, taper relief, and an annual exempt amount, as well as repeal of CGT altogether.⁷⁷ This section of the article considers the potential advantages and disadvantages of these policy alternatives.

4.1 Taxation of capital gains at marginal tax rates

Prior to the enactment of the 50 per cent CGT discount in the 1999-2000 fiscal year, net capital gains were taxed at the individual taxpayer's full marginal rates. Given the previous experience Australia has had with this approach, this is a viable alternative to the 50 per cent CGT discount. Notwithstanding that Australia's approach to taxing capital gains has, to date, been on a realisations basis, the accruals basis has been referred to in the literature as a possible alternative and it is also considered in this section of the article.

4.1.1 *Taxing capital gains on accrual*

In theory, capital gains could be taxed on an accruals basis, with taxpayers assessed annually on their accrued net capital gains. Taxation of capital gains on an accruals basis could also allow capital losses to be offset against other forms of assessable income.⁷⁸ Notwithstanding that taxing capital gains on accrual would eliminate the lock-in effect, there is no expectation of Australian policy-makers making such a change.⁷⁹

The taxation of capital gains as they accrue is consistent with a pure comprehensive income tax system. However, the impracticalities of taxation on an accrual basis – including liquidity and valuation issues – have prevented the adoption of an accrual-based CGT in Australia and most other comparable jurisdictions.⁸⁰

⁷⁷ Another option, not referred to in this article, is a lifetime capped exemption for capital gains. A lifetime exemption for all asset types was a feature of the Canadian tax system from 1985. The form of the Canadian lifetime exemption, and the types of assets to which it applied, underwent various changes in the years following its enactment. From 1996, the lifetime exemption applying to capital assets generally was repealed and it was replaced with a lifetime exemption that only applies to certain types of assets. An advantage of a lifetime exemption is that it levels the playing field for all types of assets and it addresses the current bias in the tax system in favour of owner-occupied housing. The current bias for owner-occupied housing could be addressed by the lifetime capital gains exemption replacing the main residence exemption, perhaps with a rollover provision where the disposed asset was main residence housing. One of the main disadvantages is its complexity, given that it requires taxpayers and tax administrations to track capital gains over several tax years.

⁷⁸ Instead of the current treatment where they can only be offset against capital gains. The realisations basis requires such quarantining rules because, in their absence, taxpayers would have an incentive to realise capital losses and hold assets with accrued gains.

⁷⁹ Although the CGT events in the *Income Tax Assessment Act 1997* in aggregate result in most capital gains being taxed on a realisation basis, there are some CGT events that can occur in the absence of a disposal event. It is arguable that for such events, CGT is on a basis other than realisation.

⁸⁰ In Australia, the Asprey Report noted that 'the impracticability of taxing capital gains as they accrue is universally recognised: the tax can only attempt to deal with realised gains': Asprey Review, above n 25, 570. Despite the reluctance of tax jurisdictions to tax capital gains as they accrue, there are examples of accruals taxation of capital gains. For example, New Zealand taxes financial arrangements on an accruals basis and it uses the comparative value method (an accruals basis) for the taxation of foreign investment funds.

Cunningham argued that 'no one believes that a normative income tax based upon the Haig-Simons definition could ever be fully implemented; its importance is as an ideal'.⁸¹ The fact that most tax jurisdictions do not tax all capital gains as they accrue is consistent with this view. As well as having potential issues related to liquidity and valuation, an accruals basis CGT could be costlier to administer than the current taxation of capital gains on a realisation basis.⁸²

The concerns about valuation difficulties do not apply to all types of capital gains assets, given that assets such as shares in public companies are relatively easy to value. Given that this type of asset is also relatively liquid, there is an argument for introducing an accruals basis for taxing capital gains on shares. One of the benefits would be that taxpayers would no longer have large amounts of carry-forward capital losses from shares in the event of a downturn in share market performance.

Schenk noted that liquidity problems alone do not explain the realisation-basis system of CGT.⁸³ The liquidity argument is essentially one based on cash flow being such a serious concern that monetisation should be required for an imposition of tax. Schenk highlighted the inadequacy of this argument and noted that monetisation is an insufficient trigger for taxation since there would be no CGT if there were an exemption for a swap of properties.⁸⁴ Schenk noted that for most assets the need to provide cash to pay an annual tax on the change in value is akin to any other cost of owning an asset and is one that should be borne by the taxpayer.⁸⁵ This argument is relevant to the Australian context given that there are CGT events that do not require disposal of an asset for there to be a capital gain and, in turn, the imposition of tax.

4.1.2 Realisation

There is a compelling case for restoring taxation of capital gains at full marginal rates in Australia and this can be considered the tax policy ideal. One of the main weaknesses of taxing capital gains at lower rates than other forms of income is the incentive this creates for taxpayers to characterise ordinary income as capital gains. There are efficiency costs associated with taxpayers seeking to convert ordinary income into capital gains, including the fact that governments may be required to increase the rate of other distortionary taxes to recoup some of the revenue lost to this activity.⁸⁶ CGT is largely a tax system integrity measure that protects the income tax base, because in its absence there would be an incentive to convert ordinary income into capital gains.

A tax system with a preferential CGT rate compromises vertical equity, since the heavily skewed distribution of capital gains means that high income taxpayers receive most of the benefit of the preference. Horizontal equity requires consistent treatment of taxpayers with the same income. As outlined earlier, a tax system where the proportion of taxable income that is capital gains influences a taxpayer's average tax rate is one that does not satisfy the policy criterion of horizontal equity. The integrity and fairness

⁸¹ Noël Cunningham, 'Taxation of Capital Income and the Choice of Tax Base' (1996) 52(1) *Tax Law Review* 17.

⁸² George Fane and Martin Richardson, 'Negative Gearing and the Taxation of Capital Gains in Australia' (2005) 81(254) *Economic Record* 249.

⁸³ Deborah Schenk, 'A Positive Account of the Realization Rule' (2004) 57(3) *Tax Law Review* 355.

⁸⁴ *Ibid.*

⁸⁵ *Ibid.*

⁸⁶ Auerbach, above n 50, 599.

of the tax system can be improved by aligning the tax rate on capital gains with that on other forms of income.

4.2 Indexation of capital gains

Prior to the enactment of the 50 per cent CGT discount in 1999, a feature of Australia's then regime for taxation of capital gains at full marginal rates was the indexation of the cost base of CGT assets. If the CGT discount was to be abolished and capital gains taxed at full marginal rates once again, a further consideration for policy-makers would be whether to allow the indexation of cost base. Indexation of the cost base ensures that the taxation of net capital gains applies to real rather than inflationary gains.

While there is merit in the argument that inflationary gains should not be subject to taxation, it is difficult to justify inflation adjustments to the cost base of capital gains assets and not to other parts of the tax system. Where inflation adjustments apply to capital gains and not to other parts of the tax system, there are compromises to equity and efficiency, as well as arbitrage opportunities arising from the fact that the various parts of the tax base are subject to different inflation rules. According to Burman, the non-indexation of cost base, and the resultant taxation of inflationary capital gains, is smaller than the 'inflation tax' on other forms of capital income.⁸⁷ This is because of the greater benefit that arises from taxpayers being able to defer the tax on capital gains.⁸⁸

Indexation need not be part of a regime that taxes capital gains at full marginal rates, given its effect on complexity and the current environment of low inflation. Nevertheless, policy-makers in Australia might view indexation as a necessary feature of CGT regime that taxes capital gains at full marginal rates, especially if there was a return to a high inflationary environment.⁸⁹

4.3 Separate rate schedule for capital gains

Another alternative to the CGT discount is a separate rate schedule for capital gains, similar to that which operates in the US. From a tax policy design perspective, and in accordance with equity principles, the separate schedule should include several different CGT rates, rather than one flat tax rate for capital gains. Introducing a separate rate schedule would be one way of changing the real tax rates on capital gains.

Taxing capital gains under a separate schedule would represent a significant departure from the current approach and one which would be accompanied by increased complexity. Furthermore, such a change would be difficult to justify according to tax design principles. It is questionable whether there is a tax system design principle that requires capital gains to be taxed under a separate schedule at lower rates than other income.

⁸⁷ Burman, above n 8, 147.

⁸⁸ Ibid 147.

⁸⁹ It is also of note that the Henry Review recommended a 40 per cent savings income discount for individual taxpayers, to apply to their net interest income, net residential rental income (including related interest expenses), capital gains and losses, and interest expenses related to listed shares: Henry Review, above n 39, Recommendation 14. This recommendation would address the inconsistency that would occur by indexing the cost base of capital gains assets, while not providing an inflation adjustment to other forms of capital income. The recommendation for the discount to apply to losses as well as gains would reduce arbitrage opportunities that currently exist.

4.4 Taper relief

Taxing capital gains using a taper relief system involves a lowering of the CGT rate – or the amount of capital gain to be included in assessable income – according to the length of time that an asset is held prior to disposal.⁹⁰ CGT taper relief operated in the United Kingdom for personal income taxpayers from 1998 until 2008.

The introduction of a taper relief system could allow policy-makers to increase the minimum holding period for the asset that is subject to the CGT event before the taxpayer can qualify for the CGT rate preference.⁹¹ An increase in the minimum holding period could address concerns about the generosity of the 50 per cent CGT discount after a holding period of more than 12 months.⁹² It may be that in the current regime there is an incentive for some taxpayers to time the realisation of capital gains to be as close as possible to when they qualify for the CGT discount. Notwithstanding the benefits of deferral, such timing may ensure the taxpayer receives the maximum benefit of the CGT discount.⁹³

Taper relief appears to be the least preferred option for reforming the taxation of capital gains for personal taxpayers in Australia, and it would certainly introduce more complexity into the tax system.

4.5 Annual exempt amount

An alternative to the current system of taxing capital gains in Australia is to allow all taxpayers a non-cumulative annual exempt amount (AEA) for net capital gains in each year of income. The UK and South Africa are examples of tax jurisdictions that have used an AEA.⁹⁴

Evans, Minas and Lim set out the case for the introduction of an AEA, explaining that part of its appeal is that a large proportion of personal taxpayers with small capital gains could be removed from the 'CGT net'.⁹⁵ The design of an AEA should allow taxpayers to claim the annual exempt amount without having to calculate their net capital gain in every case. Otherwise taxpayers would still need to ensure that they keep records of their CGT asset expenditure and proceeds to calculate their net capital gain for the year to ascertain that they are within the AEA.

The AEA proposed by Evans, Minas and Lim addressed this consideration by ensuring that taxpayers would qualify for the AEA where total capital proceeds from all relevant CGT events for the taxpayer are equal to or less than twice the AEA threshold.⁹⁶ This criterion would promote simplicity, as it only requires the taxpayer to consider their

⁹⁰ Minas, above n 37.

⁹¹ Ibid.

⁹² Ibid.

⁹³ Ibid.

⁹⁴ Canada is another country that operated an approximation of an annual exemption on capital gains, albeit on a narrower range of assets. Specifically, between 1977 and 1984, the Canadian tax system included an annual deduction for up to CAD 1,000 of taxable capital gains on 'Canadian securities'. The measure was repealed when Canada introduced the Lifetime Capital Gains Exemption. See Stephen Richardson and Kathryn Moore, 'Canadian Experience with the Taxation of Capital Gains' (1995) 21(Supp) *Canadian Public Policy/Analyse de Politiques* S77, S88.

⁹⁵ Chris Evans, John Minas and Youngdeok Lim, 'Taxing Personal Capital Gains in Australia: An Alternative Way Forward' (2015) 30(4) *Australian Tax Forum* 735.

⁹⁶ Ibid.

capital proceeds for the year, rather than calculate their net capital gain. Under the other AEA criterion, taxpayers choose to calculate their entitlement to the AEA when their net capital gain for the year was equal to or less than the AEA threshold.

There may be some instances, though, where the taxpayer would choose to maintain records, where they anticipated that the threshold may be exceeded. A compelling argument in favour of the AEA proposal by Evans, Minas and Lim is its main simplicity benefit – the removal of up to 71 per cent of existing Australian personal taxpayers currently exposed to the compliance burden of the CGT regime from their obligations without loss of revenue to the government.⁹⁷

The AEA proposed by Evans, Minas and Lim would still operate as a CGT-free threshold for those taxpayers with a net capital gain in excess of the threshold. That is, its purpose is not only to exempt from CGT taxpayers who meet one of the above criteria, but it would also allow taxpayers with net capital gains above the threshold to apply the AEA to reduce their taxable net capital gain by the amount of the AEA.⁹⁸ Like the tax-free threshold for income tax in Australia, the AEA proposed by Evans, Minas and Lim is non-cumulative — to the extent that a personal taxpayer is unable to use part or all of the AEA in a given tax year, it would not be available to be carried forward or backward to other tax years.

An AEA could improve vertical and horizontal equity by imposing a per-taxpayer limit on the amount of net capital gains that are eligible for the preference. Although the AEA gives effect to a zero tax rate for net capital gains up to the amount of the threshold, all net capital gains over the threshold amount would be subject to tax at the taxpayer's marginal tax rate. The important distinction between the 50 per cent CGT discount and the AEA is that the AEA imposes a per-taxpayer limit on the amount of the preference, whereas the CGT discount provides a tax preference of a very large magnitude in aggregate.⁹⁹

The AEA could also restore equity to the CGT system, as the preference for capital gains it gives effect to is progressive in its impact. In terms of the percentage by which the AEA reduces the taxpayer's real tax rate on capital gains, it is directed more towards lower-income taxpayers with capital gains, rather than being heavily skewed towards higher-income taxpayers, as is the case with the CGT discount.

While there are some benefits to the proposed AEA, it is arguable that there are some aspects of it that could potentially lead to problems post-implementation. For example, once an AEA is introduced there may be pressure to increase the threshold amount. Another concern is that the AEA could influence taxpayers to time their capital gains realisations in such a way that they 'max out' the exempt amount in each year, to the extent that this is possible.

Notably, in addition to the AEA in the UK, that jurisdiction also has a separate schedule of lower rates applying to capital gains, and these rates were recently reduced.¹⁰⁰ This is an example of the fact that despite the AEA being a type of tax preference, there can

⁹⁷ Ibid.

⁹⁸ Ibid.

⁹⁹ This impedes revenue forecasting as there is an absence of data on the accrued capital gains of taxpayers.

¹⁰⁰ As of April 2016, the rates for CGT in the United Kingdom are: basic rate taxpayers 10 per cent (down from 18 per cent) and higher rate taxpayers 20 per cent (down from 28 per cent).

be still pressure from taxpayers to provide additional concessional tax treatment for capital gains.¹⁰¹ If the same were to eventuate in Australia it would arguably constitute a 'worst-case scenario'. While the AEA may be a viable alternative to the CGT discount, the risk of the UK experience being repeated in Australia should be considered.

4.6 Repeal capital gains tax

Some commentators have argued that the total repeal of CGT in Australia is an alternative to the current system of taxing capital gains.¹⁰² While some have argued for the repeal of CGT,¹⁰³ to achieve tax neutrality between taxing consumption today or tomorrow,¹⁰⁴ we do not support a tax system that does not tax capital gains. Such a tax regime would be problematic from the perspective of vertical equity, horizontal equity and efficiency.¹⁰⁵ The inefficiency problems arise from tax planning that is aimed at characterising what would otherwise be income receipts as tax-free capital gains.¹⁰⁶

In conclusion, for the reasons that have been outlined in this section of the article, we suggest that incremental reform is a way that may address the concerns with the 50 per cent CGT discount in the short term.¹⁰⁷ The following section considers incremental reform in more detail.

5. INCREMENTAL REFORM

Tran-Nam, Vu and Andrew argued that an incremental approach is the most viable option for personal tax reform in Australia.¹⁰⁸ There is also a view in the literature that incremental changes that are too frequent may detract from the perceived stability of the tax system.¹⁰⁹ A possible incremental change to address concerns about the CGT discount is to reduce the CGT discount rate and implement an annual cap of the amount of CGT discount that a taxpayer can claim each year.

5.1 Reducing the CGT discount rate

Section 2 of this article outlined some of the concerns with taxing capital gains at preferential rates; in aggregate these concerns highlight the case for taxing capital gains at full marginal rates. Notwithstanding the arguments set out in the tax literature for capital gains to be taxed at full marginal rates, there may be some political considerations that restrain tax reform generally. Incremental reform in relation to the

¹⁰¹ It is also notable that the UK AEA is higher in magnitude than the one proposed by Evans, Minas and Lim, above n 95.

¹⁰² Such arguments are not limited to Australia. See, eg, Barry Bracewell-Milnes, 'Capital Gains Tax: Reform Through Abolition' in Barry Bracewell-Milnes (ed), *A Discredited Tax: The Capital Gains Tax Problem and Its Solution* (Institute of Economic Affairs, 1992) 1.

¹⁰³ Daley, Wood and Parsonage, above n 1, 12, citing Robert Carling, 'Right or Rort? Dissecting Australia's Tax Concessions' (Centre for Independent Studies Research Report, 2015).

¹⁰⁴ Alternative arguments are that the 'risk free' part of returns should not be assessed: James Mirrlees et al, *Tax by Design: The Mirrlees Review Vol 2* (Oxford University Press for Institute for Fiscal Studies, 2011) 284.

¹⁰⁵ The New Zealand experience of not having a comprehensive CGT has, arguably, highlighted such problems.

¹⁰⁶ This is also of concern in a tax system that taxes capital gains at preferential rates.

¹⁰⁷ The longer-term policy goal is one of taxing capital gains at the same rate as ordinary income.

¹⁰⁸ Tran-Nam, Vu and Andrew, above n 76.

¹⁰⁹ Binh Tran-Nam et al, 'Personal Income Tax Reform in Australia: The Way Forward' (2006) 21 *Australian Tax Forum* 441.

CGT discount would increase the real CGT rate so that more than 50 per cent of capital gains are taxable at all levels of income. It is possible to achieve reform of CGT that improves horizontal and vertical equity and increases tax revenue — albeit to a lesser degree than CGT at full marginal rates — by reducing the rate of the 50 per cent CGT discount.

Reducing the CGT discount may be characterised as a necessary compromise to achieve an improved policy outcome. Such a reform may have more political acceptability, although it may still involve difficulties, as the experience in Australia shows. In 2010, the then Rudd Labor Government swiftly ruled out the Henry Review recommendation to reduce the CGT discount to 40 per cent; although more recently, the Labor Opposition led by Bill Shorten proposed a 25 per cent CGT discount as one of its policies during the 2016 federal election campaign.¹¹⁰ The current Coalition government appears not to support any plans to reduce the current the 50 per cent CGT discount. The difference in CGT policy between Australia's two major political parties illustrates the 'adversarial' nature of tax reform debate referred to by Eccleston.¹¹¹ Given the apparent political difficulties associated with implementing a minor change in the rate of the CGT discount, the prospects for complete removal of the CGT appear quite limited. Nevertheless, incremental reform that improves on the current policy should be pursued.

It is apparent that the 50 per cent CGT discount does not perform well against the traditional tax policy criteria of horizontal and vertical inequity; and it causes inefficiency due to the rate difference between ordinary income and capital gains. If the reduction of the 50 per cent CGT discount is considered the most politically feasible option for reform of CGT, it is worthy of consideration. Although there are inherent problems with a rate differential between capital gains and ordinary income, a higher rate of CGT would improve vertical and horizontal equity and increase CGT revenue.

Rynne indicated his support for incremental reform, noting that it would reduce the demand for property investment.¹¹² Such reform is also supported by Daley, Wood and Parsonage who argued for a 25 per cent discount for individuals and trusts to be introduced.¹¹³ They suggested that such a reduction to the CGT discount rate could be phased in over a five-year period with the discount reduced by 5 percentage points each year. This should avoid 'shocks' to the market and a scenario of investors rushing to sell properties.¹¹⁴ Such an incremental reduction to the CGT discount rate would be a better alternative than grandfathering previous CGT rates.

It is acknowledged that such a reduction exceeds the Henry Review's recommendation of a reduction in the discount to 40 per cent. However, it has been argued that the Review, in coming to this conclusion, failed to take into account the 'additional and sizeable tax advantages for capital gains'.¹¹⁵ According to projections by the Grattan

¹¹⁰ Lenore Taylor, 'Labor promises to cut negative gearing and capital gains tax concessions', *The Guardian* (13 February 2016), <https://www.theguardian.com/australia-news/2016/feb/13/labor-promises-to-cut-negative-gearing-and-capital-gains-tax-concessions> (accessed 24 December 2018).

¹¹¹ Eccleston, above n 67.

¹¹² Brendan Rynne, 'Housing "bubble" to deflate slowly in Sydney and Melbourne as house values gently roll back', KPMG NewsRoom (21 July 2017), <http://newsroom.kpmg.com.au/housing-bubble-deflate-slowly-sydney-melbourne-house-values-gently-roll-back/> (accessed 24 December 2018).

¹¹³ Daley, Wood and Parsonage, above n 1, 3.

¹¹⁴ *Ibid* 46.

¹¹⁵ *Ibid* 36.

Institute, once fully implemented, a 25 per cent CGT discount would raise additional tax revenue of AUD 3.7 billion per year.¹¹⁶

There appears to be broad support for reducing the rate of the CGT discount, as indicated in several of the submissions to the Australian Government's 2015 Re:think Discussion Paper.¹¹⁷

5.2 Annual limit to the amount of CGT discount claimed

Currently, one of the issues with the CGT discount is that there is no upper limit of the amount of the 50 per cent CGT discount that can be claimed.¹¹⁸ Given that a large percentage of capital gains are realised by those on higher taxable incomes, introducing a limit on the amount of the CGT discount claimed each year for each individual taxpayer is a way to reduce the vertical inequity aspects of the policy in its current form. To the extent that the CGT discount shelters capital gains from full marginal rates of tax, the progressiveness of the personal income tax system is undermined. An annual CGT discount limit of AUD 50,000, accompanied by a reduced rate of CGT discount, would improve vertical equity in the tax system.¹¹⁹

Any arguments about a lack of 'political' viability of such a reform should consider that a very small proportion of taxpayers realise capital gains that exceed the proposed cap. Furthermore, the benefits of deferral and the continuation of the CGT discount, albeit at a reduced rate, would ensure that there is still a significant preference for capital gains compared to other forms of assessable income.

6. CONCLUSION

This article has considered two broad alternatives for the reform of the 50 per cent CGT discount. The first of these is the complete removal of the CGT discount and its replacement with an alternative means of taxing capital gains such as the annual exempt amount proposed by Evans, Minas and Lim. The second is retaining the CGT discount with amendments that would have the effect of better aligning it to the traditional 'good' tax system policy criteria of vertical and horizontal equity, efficiency and simplicity. This may be achieved by way of a CGT discount at a reduced rate accompanied by an annual limit on the amount of the discount that a taxpayer can claim in a fiscal year.

Incremental reform would address many of the concerns raised with the CGT discount and such reform appears to have the support of a significant proportion of the taxpayer population. While we are of the view that the CGT discount should not persist in its current form, incremental change provides the prospect of more immediate reform. A reduction in the rate of the CGT discount together with introduction of an annual CGT

¹¹⁶ Ibid 37: This is slightly different to prior Treasury estimates as their estimate is based on a subsequently released 2013-14 sample file.

¹¹⁷ For example, the KPMG submission recommended a reduction of the CGT discount to 25 per cent and that the discount apply to interest income and unfranked dividend income, as well as capital gains: David Linke and Grant Wardell-Johnson, *Tax Reform: KPMG's Submission to Treasury* (July 2015) 35, <https://assets.kpmg.com/content/dam/kpmg/pdf/2015/07/tax-reform-kpmg-submission-to-treasury-july-2015.pdf>.

¹¹⁸ For example, a taxpayer with a discount net capital gain of AUD 5 million paying tax at a marginal rate of 46.5 per cent would be receiving a tax rate preference of approximately AUD 2.325 million.

¹¹⁹ Policy-makers could also consider a limit of AUD 100,000 for years in which a large capital gain accrued over a minimum period of time, such as 20 years.

discount limit amount would constitute an improvement to the tax system in terms of vertical and horizontal equity, and efficiency. We are of the view that such incremental changes should not be accompanied by grandfathering of the current law, as this would compromise the intended improvements to simplicity and efficiency. However, even with such incremental reforms, there is the need for continued long-term policy reform to ensure that capital gains are appropriately taxed in Australia.

Capital gains taxation in Canada, 1972-2017: evolution in a federal setting

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Abstract

Capital gains taxation in Canada was introduced in 1972 following the recommendations of the Carter Commission. This article will trace the evolution of the system focusing in particular on the following three items:

- (1) the interaction between capital gains taxation and provincial succession duties as the latter were driven down to zero in the 1970s (Québec in the 1980s);
- (2) the phased introduction (1985-1988) and abolition (1994) of a generally available life-time capital gains exemption; and
- (3) the changes in the inclusion rate of capital gains in taxable income (50% in the years 1972-1988; 66.67% in 1988-1990; 75% in 1990-2000; and 75% to 66.66% to 50% in 2000 and 50% thereafter).

The article will start by setting out a brief history of capital gains taxation in Canada. Following this factual part, an examination of the three items mentioned above will be carried out followed by a brief discussion of the post-2000 period.

Key words: capital gains, death taxes, lifetime exemption, inclusion rate

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1. INTRODUCTION

The taxation of capital gains in Canada was introduced in 1972, building on the Carter Commission recommendation of 1966 that this be done since ultimately it does not matter whether capital gains, gifts and bequests are or are not called ‘income’ (Royal Commission on Taxation (Carter Commission), 1966). What does matter is that these things increase the economic power of those who are fortunate enough to receive them, and therefore should be taxed like wages, salaries, rent, dividends, interest and so on (Carter Commission, vol. 3, part A, p. 25); or put differently ‘a buck is a buck’.¹ The taxation of capital gains is in 2018 one of two taxes on wealth, or more precisely in this case an increase in wealth, in Canada; the other is the tax on real property-structures and land. Succession duties had been introduced by various provinces over the 1892-1905 period, while the federal government first imposed death taxes in 1941; these duties and taxes were abolished over the 1972-1985 period (Goodman, 1995).

This article will describe briefly the history of capital gains in Canada, then examine three selected aspects. These are: (a) the gradual shift from death taxes to capital gains taxes; (b) the effects of the short-lived Lifetime Capital Gains Exemption, and (c) the 2000 federal inclusion rates changes that were driven in part by a policy choice of Ontario. A brief discussion of the post-2000 status of capital gains taxation and a conclusion follow.

2. A BRIEF HISTORY OF CAPITAL GAINS TAXES IN CANADA

The Royal Commission on Taxation (the Carter Commission after the name of its chair, Kenneth Carter) was convened in the 1960s by the federal government; it produced a report that put forward various changes to the then existing tax regime. Prior to the publication of the report, capital gains in Canada were tax-free. Changes in 1972 to the *Income Tax Act* that implemented some recommendations of this Royal Commission brought about inclusion of 50% of realised capital gains in taxable income. This was intended to create a more progressive tax on income, since ‘[w]ages, salaries, business profits, gifts and capital gains all increase the economic power of the recipients and should be treated on exactly the same basis for tax purposes’ (Beaubier, 1972, p. 560).

The 50% inclusion rate of realised capital gains in income subject to the personal income tax was in place from 1972 to 1987. Realisation occurred on the sale of the asset and was deemed to have occurred at death but with a tax-free rollover to a surviving spouse. In June 1987, the federal government announced that ‘[t]he inclusion rate — that is, the proportion of an individual’s capital gain that is taxable — will be increased from the current rate of 50 per cent to 66 2/3 per cent in 1988 and to 75 per cent for 1990 and subsequent taxation years’.² This 75% inclusion rate was in place from 1990 to 2000 (February) when the federal Budget brought it down to 66.67%; it was further lowered to 50% in the government’s October 2000 economic statement (Department of Finance, 2000b) and has remained unchanged since then. One other notable change in the taxation of capital gains was the introduction in 1985 of a lifetime capital gains

¹ Allegedly said by the Royal Commission chair Kenneth Carter: see Macdonald (2006). The buck was common term for the Canadian dollar, now replaced by the term ‘the loonie’ (not loony!). For more details see https://en.wikipedia.org/wiki/Canadian_dollar.

² This was part of a large set of tax changes including the first steps to introducing a value added tax (VAT, termed the goods and services tax (GST)) in Canada. See Wilson (1987, p. 34).

exemption (LCGE) for all taxpayers. Since 1995, it only remains available for small businesses, farmers and fishers.

As shown in Table 1, from 1972 to 2016 (the last year available at the time of writing), capital gains for both individuals and businesses have increased 174 times in nominal terms (and in real terms 30 times).³ Table 2 shows that both the amount of taxable gains reported by individuals and the number of individuals reporting them also increased from 1972 to 2016.

Table 1: Importance of Capital Gains, by Amount, Canada, Ten Selected Years, 1972-2016 (CAD million, unadjusted for inflation)

Year	Individual	Business	Total
1972	176	89	265
1975	476	323	800
1980	2836	1896	4732
1985	2888	2615	5504
1990	8342	5930	14 272
1995	7471	6066	13 537
2000	20 465	11 491	31 956
2005	17 641	12 723	30 364
2010	16 814	14 218	31 032
2016	25 735	21 553	47 228

Sources: Statistics Canada, Financial and taxation statistics, enterprises and corporations, various series (Tables 33-10-0011-01, 33-10-0006-01 and 33-10-0016-01, formerly CANSIM Tables 180-0001, 180-0003 and 181-0001 respectively); Canada Revenue Agency, *Income tax statistics*, Table 2, various years.

³ Using the CPI to deflate them: <https://www.bankofcanada.ca/rates/related/inflation-calculator/>.

Table 2: Importance of Capital Gains, by Amount and Share, Individuals, Canada, Ten Selected Years, 1972-2016 (CAD '000, nominal and %)

Year	A Total capital gains from all sources	B Taxable amount of capital gains	C Number of payers reporting capital gains	D Capital gains, % of total taxable income	E % of taxpayers reporting capital gains	F % of tax filers reporting capital gains
1972	\$ 351,897	\$ 175,939	n.a.	0.9%	n.a.	n.a.
1975	\$ 1,065,321	\$ 476,213	n.a.	1.6%	n.a.	n.a.
1980	\$ 5,944,367	\$ 2,836,274	n.a.	n.a.	n.a.	n.a.
1985	\$ 5,505,676	\$ 2,887,888	594,163	2.9%	5.3%	3.7%
1990	\$ 11,095,885	\$ 8,341,904	626,050	2.1%	4.5%	3.3%
1995	\$ 10,366,326	\$ 7,471,180	1,003,660	1.6%	7.12%	4.9%
2000	\$ 29,812,896	\$ 20,465,006	2,409,800	3.3%	15.6%	10.8%
2005	\$ 33,838,117	\$ 17,641,493	1,023,750	2.4%	13.4%	9.2%
2010	\$ 29,287,705	\$ 16,814,504	1,564,530	1.9%	9.9%	6.6%
2016	\$ 45,479,320	\$ 25,734,582	2,583,870	2.3%	14.40%	9.7%

Source: Canada Revenue Agency, *Income tax statistics*, various years Table 2

Notes: Column A shows the total realised net capital gains from all sources and all income levels. Column B subtracts the allowable capital losses and presents taxable capital gains from all sources. Column C presents, when available, the number of payers reporting capital gains. Column D presents total taxable capital gains as % of total taxable income for that year. Column E is the % of tax filers and Column F the % of taxpayers who reported realised capital gains.

We now turn to the first of the three specific topics to be examined in some depth, which is the replacement of death taxes by capital gains taxation.

3. THE REPLACEMENT OF DEATH TAXES BY CAPITAL GAINS TAXATION

Death taxes began to be undermined before the introduction of capital gains taxation in Canada by decisions taken by the provinces of Alberta and Saskatchewan to reduce their death tax rates in part by rebating the federal amount paid out to them. However, the full disappearance of death taxes followed the introduction of capital gains taxation. This happened since one of the main purposes of the death tax was to act as a 'check' on the incomes of the wealthy and to make up for tax avoidance choices that were used throughout an individual's lifetime. But as Bird (1978, p. 138) noted, '[w]hen capital gains were taxed directly, as in the 1971 Act, there was much less need for death taxes

for either revenue or “catch up”. In order to avoid double taxation, with individuals seeing their capital gains taxed both throughout their lifetime and again upon their death, the abolition of death taxes and the introduction of capital gains taxation was carried out simultaneously at the federal level in 1972. At the provincial level, first Prince Edward Island then the other three Atlantic provinces did away with the succession duties. All provinces abolished succession duties in the 1970s except for Quebec, which eliminated the tax in 1985.⁴

Table 3 shows the federal and provincial succession duties revenues for five years in the 1965-1980 period. In 1972, federal revenues from capital gains taxation introduced that year were most likely of the same magnitude as federal succession duties⁵ and exceeded them afterwards. Table 3 also shows the importance of two provinces in provincial succession duties and the impact on revenues with the drop from 1975 to 1980 of various provinces abrogating these duties in the 1970s. The dominant share of Québec in 1980 is explained by the fact that it was then the sole province still actively collecting succession (and accession in this case) duties while other provinces obtained revenues from the closing of past estates.

Table 3: Succession Duties, Canada, All and Two Largest Provinces, Five Selected Years, 1965-1980 (CAD million, current)

Year	Federal revenue	Provincial (all provinces) revenue	Ontario revenue	Québec revenue
1965	101	111	55	42
1970	111	155	78	50
1972	80	150	75	46
1975	6	150	73	39
1980	1	71	23	43

Source: Canada and all provinces: Statistics Canada, *Direct taxes, persons*, Table 36-10-0178-01 (formerly CANSIM Table 380-0543); Ontario and Québec: Statistics Canada, *Direct taxes, persons, provincial accounts*, Table 36-10-0337-01 (formerly CANSIM Table 384-0027).

Note: Ontario and Québec are included in the provincial total.

⁴ The Parti Québécois, in power in Quebec from 1976 to 1985, was a self-described social democrat party that believed in death taxes as a redistributive measure. It thus abolished the taxes only in early 1985 after a change in Finance minister.

⁵ Direct data on the yield resulting from the inclusion of capital gains in the personal income tax base is not available as it is not a standalone tax. But Table 2 above indicates individual taxable capital gains of CAD 175 million that, if taxed at an average tax rate of 50%, would yield CAD 90 million of tax revenue.

We now turn to the birth and death of the lifetime capital gains exemption.

4. LIFETIME CAPITAL GAINS EXEMPTION

The federal government introduced the generally available lifetime capital gains exemption (LCGE) in 1985 with the following aims (Department of Finance, 1985, p. 3):

The budget proposes a major initiative to encourage risk-taking and investment in small and large businesses and to assist farmers by providing a cumulative tax exemption for capital gains up to a lifetime limit of \$500,000. This change will support equity investment and broaden participation by individuals in equity markets. In addition, it will improve the balance sheets and financial health of Canadian companies. It will provide a tax environment that is more conducive to high technology companies raising capital. It will encourage individual Canadians to start new businesses and will help small businesses grow. The number of individuals benefiting from the exemption will depend on the response of individual Canadians.

The exemption was to be phased in over a period of six years with a cumulative limit of \$250,000 in taxable capital gains in the sixth and subsequent years. The phasing-in was planned as follows: \$10,000 in taxable gains in 1985; \$25,000 in 1986; \$50,000 in 1987; \$100,000 in 1988; \$150,000 in 1989; and \$250,000 in 1990 and thereafter. In 1987, the federal government ended the growth of the LCGE (Department of Finance, 1987, p. 11) thereby halting the cumulative limit at CAD 100,000 of capital gains with the exceptions noted below; this was part of the changes that were put forward ‘to broaden the tax base, increase fairness and help finance personal income tax rate reductions’.

However, the original LCGE maximum for farmers, fishers and small businesses remained in place, reaching its planned maximum of CAD 500,000 in 1990. This maximum was increased to CAD 750,000 in 2007 and then to CAD 800,000 in 2014. In 2015, this amount was indexed to inflation for small business shares (SBC) and set at CAD 1,000,000 for farmers and fishers; the SBC amount indexed to inflation is worth CAD 848,252 in 2018 while the CAD 1,000,000 amount is not indexed to inflation but cannot be lower than the SBC amount.⁶ The sole justification provided for this new differentiated treatment is ‘to allow farm and fishing business owners to maintain more of their capital for retirement’ (Department of Finance, 2015, p. 122).

The federal government eliminated the generally available LCGE in 1994 (Department of Finance, 1994, p. 42). In 1994, one could mark up the value of capital assets without selling them in order to use up any unused LCGE space; thus one used accrued capital gains rather than realised capital gains for this. This explains the extremely high tax expenditure of CAD 8,815 million associated with the generally available LCGE in 1994, which will be shown in Table 6 in section 4.3 below.

⁶ See Taxtips.ca, ‘Lifetime capital gains exemption (LCGE)’, <https://www.taxtips.ca/smallbusiness/capitalgainsdeduction.htm>.

Three dimensions of LCGE are now examined: (a) its impact on investment; (b) its impact on retirement income, and (c) its relationship with the distribution of income.

4.1 The impact of LCGE on investment

The generally available LCGE lowered the effective amount of capital gains subject to taxation. McKenzie and Thompson (1995) examined the effects of the exemption on the cost of equity financing of corporations in order to evaluate the impact of the generally available LCGE on investment. Their model is based on the neoclassical investment theory whereby a firm will maximise profits by investing at the level where the user cost of capital is equal to the marginal product of capital.

The study by McKenzie and Thompson (1995) examined two samples of stocks listed on the Toronto Stock Exchange in order to control for industry and firm-specific bias. Sample 1 was all stocks (270) listed on the Toronto Stock Exchange; sample 2 was a subset made up of firms with both preferred and common shares listed (51, and thus 102 shares); the authors expected a greater impact of the LCGE on common than preferred shares. They then used the impact on the cost of capital and elasticities found in the literature linking this cost to real investment to ascertain the impact of the LCGE. They concluded that:

[i]t is therefore difficult to draw strong conclusions about the effect of the capital gains exemption on the cost of capital and, therefore, on investment. Our estimates suggest that the increase in investment spending may have been negligible or as high as 6 per cent. More research is required before we can decide the issue with more confidence (McKenzie & Thompson, 1995, p. S113).

Since the study was conducted using companies listed on the TSE 300 the results cannot be applied to small businesses that are not listed on the stock market, and therefore the impact that the LCGE could have on encouraging investment in small business is not fully captured. However, a lifetime capital gains exemption that generally applies to all assets is an inefficient means of stimulating small business investment (Mintz & Richardson, 1995).

4.2 LCGE and retirement savings of farmers and small business owners

One argument used to justify the LCGE is that farmers and small business owners (SBOs) cannot save for retirement as easily as salaried workers. The two main tax advantageous savings vehicles for retirement in Canada are the individual owned Registered Retirement Savings Plan (RRSP) and the employer-sponsored Retirement Pension Plan (RPP). Both allow deducting from taxable income the allowable contribution of the taxpayer and sheltering from personal income tax until withdrawal (required at age 71; it was 69 from 1996 to 2007) the returns to capital. But farmers and SBOs are often reinvesting their earning in their businesses and thus cannot easily make use of RRSPs and rarely have access to an RPP. Their wealth is largely held in less liquid assets that would be sold to fund their retirement. Since the profit from such a sale constitutes a capital gain they could be taxed more heavily on their retirement funds than the majority of Canadians without the LCGE.

Jog and Schaller (1995) examined the retirement-related tax choices of farmers and SBOs using a sample of tax returns made up of three groups: farmers, SBOs and the

general public. They did this for the 1982-1990 period, thus covering pre- and post-LCGE years. In the case of farmers, they noted:

In principle, one might imagine that the farm LCGE was a substitute for the tax preference for retirement savings available to the general public. This does not appear to be the case in practice. Almost as large a proportion of the beneficiaries of the farm LCGE (23%) made an RRSP contribution as did the individuals in our full sample (30%)... Moreover, for all age groups, the average (farmer) RRSP contribution was at least 85 per cent as large as the average RRSP contribution for the typical individual in our full sample. For old beneficiaries (and the majority of beneficiaries were old), the average (farmer) RRSP contribution was 24 per cent higher than that for the typical individual in our full sample (Jog & Schaller, 1995, p. S148).

Thus the evidence does not support the argument that farmers cannot make use of RRSPs.

This is also the case for SBOs since:

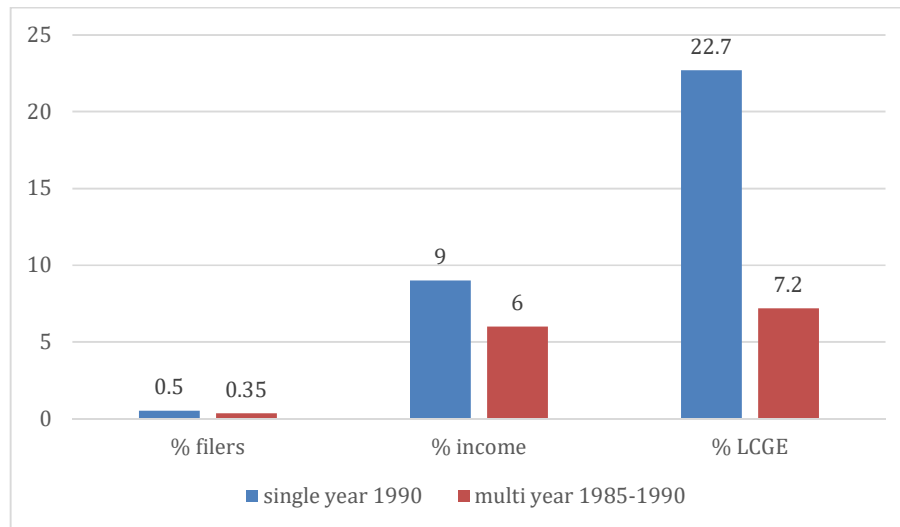
...the majority of small business LCGE was claimed by people who were not at or near retirement age. Almost three-quarters of small business LCGE was accounted for by high income individuals. The average income of these individuals was about five times as large as that of the typical individual in our full sample. Finally, about three-fifths of small business LCGE was claimed by people who made high contributions to two other programs (namely RPPs and RRSPs) which offer tax preferences for retirement savings. Even the low contributors had an average income which was substantially higher than the typical individual in our full sample. This cast some doubt on the idea that low income prevented them saving for retirement (Jog & Schaller, 1995, p. S157).

Overall one can conclude from the work of Jog and Schaller (1995) that the LCGE often served as a complement to retirement savings for small-business owners and 'middle' to 'high income' farmers but did benefit 'low income' farmers.

4.3 LCGE and income distribution

Davies (1995) examined the use of the LCGE by income group using both a one-year (1990) and a multi-year (1985-1990) perspective. One-year results showed a greater concentration of the LCGE in upper income groups than multi-year results. Figure 1 illustrates this for the highest income group. This is similar to the findings of Jog and Schaller (1995) discussed above.

Fig. 1: Three Tax Indicators: Proportion of Canadian Tax Filers, Income and LCGE (% , single and multi years) in the top income group

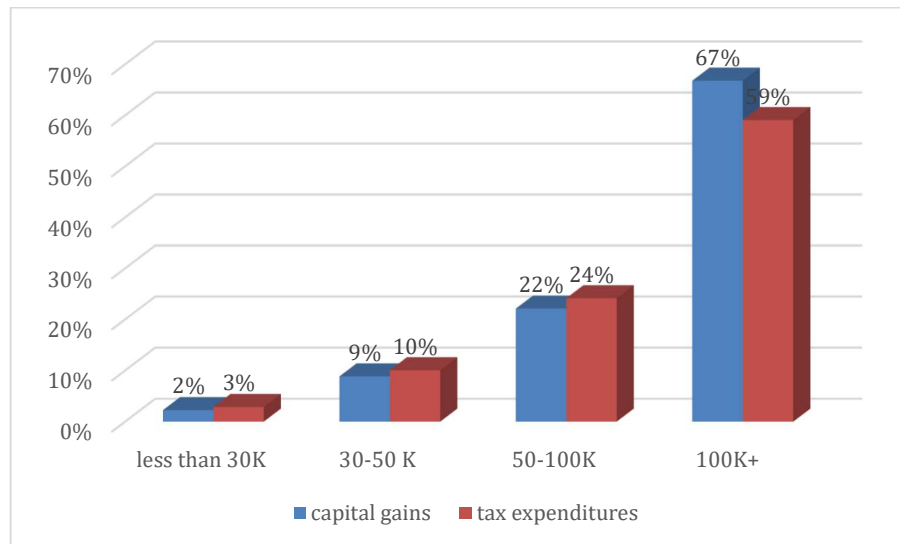


Source: Davies (1995, table 7 p. S168); see also Table 7 below.

Note: Top income group is 250 000 \$ + (CAD)

Overall the evidence discussed above shows that the LCGE is not a very useful policy tool. Yet it reduces the revenues of the federal and provincial governments. Mintz and Wilson (1995) present evidence on the tax expenditure associated with the LCGE; it increased from CAD 394 million in 1985 to CAD 1,532 million in 1991 (Mintz & Wilson, 1995, p. S180). They also present evidence on the tax expenditure by income group; we focus on 1991 in Figure 2. It shows a high concentration in the two higher income groups.

Fig. 2: Share of Capital Gains Amount and LCGE Tax Expenditure for Four Income Groups, 1991 (%)



Source: Mintz and Wilson (1995, p. S180, Table 4) and calculations by authors.

Given the content of this section, we present updated relevant information in Tables 4 to 8.

Table 4 shows the relative importance of capital gains in capital income for all Canadians. It shows an almost fivefold increase in the share of capital gains in capital income from 1972 to 2016. Table 5 shows the shares of capital gains reported by the top income earners in Canada for the same period. Capital gains have become more concentrated over time in the hands of the top income group.

Table 4: Importance of Capital Gains in Capital Income, Canada, Six Years, 1972-2016 Interval (CAD million, current)

Year	Capital gains	Capital income	% capital gains in capital income
1972	149	2,913	5.1%
1980	2,750	21,531	12.8%
1990	8,341	49,241	16.9%
2000	20,465	56,251	36.4%
2010	17,533	81,563	21.5%
2016	27,735	108,545	23.7%

Source: CRA, *Income tax statistics*, various years.

Note: Capital income is the sum of capital gains, dividends and interest earned by individuals.

Table 5: Importance of Capital Gains, Top Income Group, Canada, Six Years, 1972-2016 Period

Year	A % of total capital gains reported by top income group	B % capital gains in capital income of the top income group	C Share of income of the top income group in total income
1972	8.4%	8.6%	0.2%
1980	3.7%	3.7%	1.4%
1990	31.6%	13.8%	4.6%
2000	45.6%	52.5%	9.1%
2010	49.9%	8%	10.2%
2016	50.8%	35.0%	10.0%

Source: Canada Revenue Agency, *Income taxation statistics*, various years.

Note: The first column, A, represents the share of capital gains recorded by filers in the top income group. Column B represents the share of capital gains in the financial income of members of the top income group. Column C shows the share of income assessed for members of the top income group as a percentage of total income assessed. The threshold of CAD 200,000 defined the top income group until 1985 when it was increased to CAD 250,000 and has not changed since.

Table 6 presents the relative importance in terms of tax expenditures of the various components of the LCGE over time. The year 1988 is the first with the full-fledged LCGE available and 1994 the year of its abolition. Table 7 examines in some detail the capital gains tax expenditures associated with the personal income tax, highlighting the importance of the non-taxation of gains associated with the sale of the principal residence. Finally, Table 8 presents information on the tax expenditures associated with the capital gains subject to the corporate income tax.

Table 6: Tax Expenditure from LCGE Exemption, Individuals, Selected Eight Years, 1988-2015 Interval, Canada (CAD million, current)

Year	A General LCGE*	B Farmers	C Small Business	D Total
1988	855	225	415	1,495
1990	755	290	580	1,625
1994	8,815	470	1,725	11,010
1995	34	275	590	899
2000		325	740	1,065
2005		255	430	685
2010		325	540	865
2015		620	775	1,395

Source: Department of Finance, Canada: *Report on Federal Tax Expenditures*.
 Note: the generally available LCGE was terminated in 1994.

Table 7: Capital Gains, Personal Income Tax Expenditures, Main Items and Total, Canada, Six Years, 1990-2015 Interval (CAD million, current)

Year	A LCGE exemption	B Non-inclusion of capital gains on principal residence	C Partial inclusion of capital gains	D Total expenditure*
1990	1,625	2,390	695	4,710
1995	899	1,085	405	2,389
2000	1,065	1,000	2,500	4,565
2005	685	3,465	2,840	6,630
2010	865	4,105	3,630	8,600
2015	1,395	6,195	5,755	13,345

Source: Department of Finance, Canada: *Report on Federal Tax Expenditures*, various years.

* This column, author calculations. Total does not include tax expenditures associated with numerous small capital gains; these amount to less than CAD 100 million in 2015.

Table 8: Capital Gains, Corporate Income Tax Expenditures, Canada, Six Years, 1990-2015 Interval (CAD million, current)

Year	A Partial inclusion	B Refundable capital gains for investment and mutual funds corporations	C Total*
1990	417	81	498
1995	595	150	745
2000	2,465	645	3,110
2005	4,210	345	4,555
2010	3,285	185	3,470
2015	5,890	1,000	6,890

Source: Department of Finance, Canada: *Report on Federal Tax Expenditures*.

* This column, author calculations. Total does not include tax expenditures associated with numerous small capital gains; these amount to less than CAD 100 million in 2015.

We now turn to the evolution of inclusion rates in 2000.

5. CHANGES IN 2000 IN THE INCLUSION RATE OF CAPITAL GAINS

Let us first recall that the inclusion rate had been 50% from 1972 to 1988 when it became $\frac{2}{3}$ rd; as announced in 1986, it went up to 75% in 1990. Vaillancourt, Kerkhoff and Godbout (2018, table 3) show that in both years before the increased inclusion rate there were higher capital gains realisation than in the year of the increase. The 2000 February federal Budget (Department of Finance, 2000a, p. 94) proposed a decrease in the personal capital gains inclusion rate from 75% to $\frac{66 \frac{2}{3}}{100}$ % effective from that time to ensure ‘that businesses have access to the capital they need in an economy that is becoming increasingly competitive and knowledge-based’. This brought the inclusion rate back to what it was before 1990. But this did not settle the overall inclusion rate for 2000. The Ontario government proposed a more important decrease in the capital gains tax inclusion rate under its provincial income tax than the February 2000 federal Budget. The May 2000 Ontario Budget (Ministry of Finance, Ontario, 2000, p. 88) established a schedule for the inclusion rate to decrease from the then current 75% to $\frac{66 \frac{2}{3}}{100}$ % immediately and then to 62% in 2001, 58% in 2002, 54% in 2003 and 50% in 2004.

Grady (2000) argued that this decrease altered the definition of income – which is not permitted under the Canada Revenue Agency guidelines for the collection of the provincial tax-on-income – but more importantly acted as a gateway to further reductions in the rate until the elimination of the tax altogether. Drache (2000) feared that the government could reintroduce succession duties to make up for declining capital gains taxes revenue. While Grady recognised the productivity and investment benefits linked with lower rates on capital gains, he found that it would not be equitable for Canadians, as investors would choose to move their investments into the lowest provincial tax jurisdiction. This, Grady (2000) concluded, was the beginning of a ‘Balkanization’ of Canada as the provinces each compete for investors by creating favourable tax environments for investment.

The 2000 Ontario Budget caused, implicitly if not explicitly, the federal government to rethink their policy on capital gains. This a rare instance where the proposed tax policy of a Canadian province has affected federal tax policy so directly and so quickly. In October of 2000, the federal Finance Minister announced in his ‘mini- budget’ that the federal Budget would further decrease the personal capital gains inclusion rate from $\frac{66 \frac{2}{3}}{100}$ % to 50% (Department of Finance, 2000b). It also increased the capital gain rollover available to small businesses. These changes were proposed with the intent of boosting investment and productivity in the small business sector while also assisting small businesses in savings, though it complicated tax filing in 2000. Taxpayers had to match the realisation date to the inclusion rate, i.e., 75% from 1 January 2000 until 1 February 2000, $\frac{66.67}{100}$ % from 2 February 2000 to 17 October 2000, and 50% for the rest of the calendar/personal income tax year.

These changes in the inclusion rate took place both in a specific context and as part of a more general debate on capital gains taxation. We first present the specific context of the federal and Ontario reforms and then turn to the general debate.

5.1 Federal context of the 2000 reforms

In the case of the federal government, a structural Canadian budget deficit appeared in 1973 but became an important policy and political issue only in the early 1990s with

credit watch warnings and comparisons of the Canadian \$ with the Mexican peso.⁷ The federal government Budget of 1995 introduced cuts in transfers to provinces, unemployment insurance, defence and international aid that eliminated the deficit in 1997 and generated surpluses until 2008. The use of these annual surpluses became an object of public policy debate. Mintz and Wilson (2000) and Robson, Mintz, and Poschmann (2000) proposed a reduction in the capital gains tax inclusion rate from 75% to 66 2/3%. Their reasoning was that businesses can distribute income in the form of capital gains (implicitly) or dividends (explicitly). The dividend tax credit found in the personal Income Tax Act resulted in dividends receiving a more favourable tax treatment than capital gains when the inclusion rate of capital gains in taxable income was 75%. A reduction in the inclusion rate would create a more balanced relationship between the two types of income in terms of their tax treatment.

5.2 Ontario context of the 2000 reforms

Turning to the Ontario context, it suffered in 1990-1995 low economic growth caused in part by economic difficulties associated with the introduction of the Canada-United States Free Trade Agreement (CUFTA, the predecessor of the North American Free Trade Agreement (NAFTA) of 1994). The left-leaning provincial New Democratic Party (NDP) government in power then chose to incur deficits and thus increase public debt to stimulate the economy. The election of the right-leaning Progressive Conservative (PC) government in 1995 was associated with policies reducing the size of the provincial government and thus provincial taxes. One demand of this government was for more autonomy in collecting provincial personal income taxes. From the mid-1950s onward to 2000 (Bird & Vaillancourt, 2006), provinces other than Québec (which collects its personal income tax itself) taxed personal income through the application of a surtax on the basic federal income tax ('tax on tax') and then adjusted this amount through various surtaxes, or tax credits (Guimond & Vaillancourt, 2013). The federal government administered both federal and provincial personal income taxes free of charge with only one tax form for taxpayers to fill out. However, this system gave provinces little leeway in setting the progressivity of their personal income tax as they had to use the structure of the federal income tax – the number of brackets, range of each bracket and federal tax rates – as a building block. Due to the constraint of the 'tax-on-tax' system, Ontario threatened to follow in the footsteps of Québec and collect its own personal income tax. The federal government responded to this by allowing provinces to elect to switch to a 'tax-on-income' system, thus giving the provinces the freedom to determine their own number of tax brackets, the range of each bracket and their respective rates; they were still to be required to use the same definition of taxable income as the federal government to maintain the collection arrangements.

5.3 The general debate

Having presented the two specific contexts, we now turn to the general debate on taxing capital gains. In summary fashion, it can be noted that proponents argue that the progressivity of the taxation of capital gains and its ability to capture income that may not have been normally included in the taxation on personal income make such taxation indispensable. By contrast, opponents such as Clemens, Lammam and Lo (2014) cite

⁷ See, e.g., Thomas Courchene, 'Half-way home: Canada's remarkable fiscal turnaround and the Paul Martin legacy', Institute for Research on Public Policy, 3 July 2002, <http://irpp.org/research-studies/half-way-home/> (accessed 19 December 2018).

numerous flaws in the system: (a) incentives to not sell investments rather than reallocate and reinvest; (b) a negative impact on investment and entrepreneurial activity in Canada and movement of capital in the international market; (c) its inability to adjust for inflation or temporary income shocks, and (d) its collection cost. These can be considered in greater detail as follows.

1) In the presence of capital gains taxes, investors are likely to postpone reallocation of assets until the return differential is sufficient to offset the capital gains taxes imposed on the disposal of assets (Abeysekera & Rosenbloom, 2002). This phenomenon, known as the ‘lock-in effect’, reduces the amount of capital being reallocated and reinvested. Reductions in the tax rates on capital gains reduce the investment capital locked-up as the cost of switching decreases.

2) Capital gains taxes pose a significant concern for those looking to invest in small businesses and start-ups as the reward given to investors and venture capitalists for their risk often lies in equity shares of the new company. Reductions in the capital gains tax rate may ease the concerns investors have of locking-in their investment for long periods of time and allow them to invest more often and in riskier projects without fear of their money being stuck in a business that did not pan out.

In the same vein, proponents of the reduction of the rate of capital gains taxes often refer to the changing position of Canada in the international investment market. As other Organisation for Economic Co-operation and Development (OECD) countries reduce their rates on capital gains, Canada moves from being an average-taxed country to a high-taxed country. Comparisons between Canada and the other OECD countries as well as between Canada and the United States often resulted in Canada being deemed less attractive for foreign investment. The fear was that having higher costs of capital may cause foreign investors and even Canadians to look to invest their money elsewhere.

3) A third issue is the failure of the capital gains taxes in Canada to account for inflation. The concern is that because the initial capital cost is not indexed to inflation, those paying the tax on realised gains are paying taxes on an increased value owing partially or entirely to inflation and not to an increase in the real value of the asset. Some countries have solved this by including a consumer price index table in their tax returns and allowing filers to multiply the value of their assets by the inflation index to find the true value of the gains. This issue is exacerbated by the ‘bunching effect’ since the realisation of a capital gain may temporarily place a taxpayer into a higher tax bracket and therefore not accounting correctly for an individual’s lifetime ability to pay.

4) Finally, the receipt of capital gains income generates higher compliance costs for taxpayers than government transfer payments or wage income but lower compliance costs than for self-employment or rental income (Vaillancourt, Roy César & Silvia Barros, 2013, Table 4b).

6. THE WAY FORWARD

Since 2000, there has been little change in the treatment of capital gains in Canada. Tables 9 and 10 present information respectively on the geographic distribution of capital gains and on their importance for the three richest group of taxpayers. Table 9 shows a fairly stable distribution of the number of tax filers with taxable capital gains and of their value across the five regions of Canada; noteworthy is that in the East

(Atlantic provinces, Québec and Ontario) the share of gains is smaller than the share of tax filers while in the West (prairie provinces and British Columbia) the reverse is observed. Table 10 shows a growth in the share of capital gains in the hands of the three top income groups; in 2014, 75% of capital gains were in the hands of these three groups that account for 23% of tax filers. This concentration has increased since 2005 due in part to inflation,⁸ and is seen by some as a possible target for a federal government that introduced a new maximum personal income tax rate of 33%⁹ shortly after its election (October 2015). In the lead up to the federal budget of 2017, various commentators indicated that they feared an increase in the inclusion rate of capital gains,¹⁰ but it did not materialise. One of three measures put forward in July 2017 to increase tax fairness between the self-employed and wage earners was to make it more difficult to convert the income accumulated in small corporations into capital gains or to use more than one LCGE to extract it from the business.¹¹ Negative reactions from small business associations¹² and the medical community (see Canadian Medical Association, 2017) were very strong; the minister dropped this aspect of his reform in October 2017.

⁸ Of 18.9% over the period: <http://www.bankofcanada.ca/rates/related/inflation-calculator/>.

⁹ This was done by adding a fourth bracket for those with taxable income above CAD 202,000; the highest rate previously was 29%.

¹⁰ For a good discussion of this issue, see Golombek (2017); Grant Thornton (2017).

¹¹ For a presentation of the document entitled 'Tax Planning Using Private Corporations', see Department of Finance (2017).

¹² For example <https://www.cfib-fcei.ca/sites/default/files/article/documents/5648.pdf>.

Table 9: Share of Capital Gains, by Region, Number of Tax Filers and Value, Canada, 2005, 2010 and 2015 (%)

	A Atlantic		B Quebec		C Ontario	
Year	Number	Value	Number	Value	Number	Value
2005	4.7%	3.3%	20.1%	14.8%	40.8%	37.6%
2010	4.3%	2.7%	21.2%	17.6%	39.5%	35.9%
2015	4.4%	3.12%	19.2%	17.9%	42.3%	38.64%
	Prairie		British Columbia		Canada	
	Number	Value	Number	Value	Number	Value
2005	18.8%	24.1%	15.1%	18.4%	99.5%	98.3%
2010	18.8%	23.2%	15.5%	18.0%	99.4%	97.33%
2015	18.04%	1.9%	15.9%	18.0%	99.5%	99.9%

Source: Canada Revenue Agency, *T1 Final statistics*, Table 5, 2017, 2012, 2007.

Note: The Canadian total is not equal to 100% since tax filers from the Northern territories and those living abroad are not included in this Table.

Table 10: Share of Capital Gains, Top Three Income Groups (CAD), by Number and Value, Canada, 2005, 2010 and 2015 (%)

Yr	100,000 – 149,999		150,000 – 249,999		250,000+	
	Number	Value	Number	Value	Number	Value
2005	7.4%	9.9%	3.9%	11.9%	3.3%	46.6%
2010	10.3%	10.9%	5.9%	13.0%	4.6%	49.9%
2015	11.2%	10.3%	6.4%	12.5%	4.7%	51.8%

Source: Canada Revenue Agency, T1 Final statistics, Table 5, 2017, 2012, 2007.

7. CONCLUSION

This article presented a brief history of the taxation of capital gains in Canada. It shows how capital gains taxation through their partial inclusion in taxable income replaced the death taxes in the 1970s, how capital gains tax revenues were reduced for a short period by the introduction of a general lifetime capital gains exemption (LCGE) in the 1980s but then bolstered by the narrowing of this exemption and by an increase from 50% to 75% of the inclusion rate in the 1990s. It also examines how in a federal country a specific tax choice of its largest constituent unit (Ontario in 2000) was quickly followed by a change in federal tax policy. While capital gains taxation in Canada clearly could be improved mainly through indexing to account for inflation in the calculation of taxable gains, in its current form it plays a role in ensuring tax fairness in Canada.

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New Zealand's 'experience' with capital gains taxation and policy choice lessons from Australia

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Abstract

New Zealand taxes a number of types of capital gains as ordinary income at the standard income tax rates but it is an outlier within OECD countries for not having a separate comprehensive capital gains tax (CGT). Over the years, numerous proposals for a CGT have been made by political opposition parties as part of their policy platform; none of these parties have been successful in forming part of a government and, as such, their proposals have failed to come to fruition. The Tax Working Group in 2009 came very close to recommending a CGT for New Zealand as part of a portfolio of tax policy options. The bright-line test for the purchase and sale of residential property within two years of acquisition was introduced in 2015. The debate nevertheless continues over whether New Zealand should embrace a formal standalone CGT.

This article reviews previous attempts at introducing a CGT into New Zealand, traverses the ongoing debate, and outlines some of the key policy choices that need to be carefully examined should a future government announce that it is working on a CGT. The analysis is undertaken within a comprehensive tax base framework which applies income tax to net economic gain, adjusted for inflation. The article then considers modifications to this 'ideal' framework based on the design principles of equity, efficiency, simplicity, sustainability and policy consistency. Given Australia has had a CGT regime in place since 1985, with the regime going through several amendments in the intervening years, much of this analysis is drawn from that experience. In particular, Australia's politically controversial grandfathering clause, indexation versus discount model, and exemptions and concessions are discussed. The article concludes by providing recommendations as to 'ideal' policy choices should a CGT be again promoted as tax policy in New Zealand.

Key words: Australia, capital gains tax, New Zealand, possible reform

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1. INTRODUCTION

Incorporating provisions in a tax regime to impose tax on capital has long been regarded as difficult, both in theory and in practice.¹ Despite this difficulty, most developed nations have introduced regimes for taxing capital gains and New Zealand is a notable outlier within Organisation for Economic Co-operation and Development (OECD) countries for not having a separate capital gains tax (CGT). It does, however, tax a number of types of capital gains as ordinary income at the standard income tax rates. Over the years, numerous proposals for a CGT have been made by opposition parties as part of their policy platform; none of these parties have been successful in forming part of a government and, as such, their proposals have failed to come to fruition. The Tax Working Group (TWG) in 2009 came very close to recommending a CGT for New Zealand as part of a portfolio of tax policy options, but nevertheless failed to do so. The latest reform in this area, the bright-line test for the purchase and sale of residential property within two years of acquisition, was introduced in 2015. This was extended to five years in March 2018. However, debate continues over whether New Zealand should embrace a formal standalone CGT, with a CGT a notably contentious topic of New Zealand's political debate compared to that in other countries. This is in contrast to other areas of taxation reform where New Zealand has a very strong record of principled tax reform over many decades (the country's goods and services tax (GST) for example introduced in 1985 being considered a model of such a tax for countries to follow and benchmark for other such taxes to be measured against²).

This article reviews previous attempts at introducing a CGT into the New Zealand tax regime, traverses the ongoing debate, and outlines some of the key policy choices that need to be carefully examined should a future government announce that it is working on a CGT. The analysis is undertaken within a comprehensive tax base framework which applies income tax to net economic gain, adjusted for inflation. The article then considers modifications to this 'ideal' framework based on the design principles of equity, efficiency, simplicity, sustainability and policy consistency. Given Australia has had a CGT regime in place since 1985, with the regime going through several amendments in the intervening years, much of this analysis is drawn from that experience.

As to why Australia should be looked at for guidance, Australia is frequently considered as a first source of 'inspiration' for tax policy by New Zealand, and vice versa. This is in part due to the close relationship of the two jurisdictions and the relative similarity of their tax systems over a long period of their history. Income taxation itself was introduced in both societies in quite similar forms at around the same time (1891 in the then British colony of New Zealand, and the mid-1890s for several of the Australian colonies). Recent examples include Australia basing its goods and services tax (GST) model on the earlier New Zealand model, and New Zealand developing an approach for taxing goods purchased electronically based on the Australian approach. In the context of this article, since Australia already has a CGT, it should not come as a surprise that it would be the first choice for New Zealand to review.

¹ Gordon Cooper and Chris Evans, *Australian CGT Handbook 2016-17* (Thomson Reuters, 8th ed, 2016) [1120], citing the International Monetary Fund, working paper (1991).

² See Rita de la Feria and Richard Krever, 'Ending VAT Exemptions: Towards a Post-Modern VAT' in Rita de la Feria (ed), *VAT Exemptions: Consequences and Design Alternatives* (Kluwer, 2013) 3, 10.

In particular, in the CGT context, Australia's politically controversial grandfathering clause, indexation versus discount model, and exemptions and concessions, are discussed. The rationale for the replacement of the indexation of the cost base nearly two decades ago with the 50 per cent discount is of particular relevance to this discussion as is the most recent debate around the perceived generous nature of this discount. Recommendations of the Australia's Future Tax System review (Henry Review), which included proposed changes to the CGT regime to ensure taxes supported productivity, participation and growth, are analysed. These recommendations revolved around streamlining small business CGT rules (Recommendation 17) and a common discount of 40 per cent for interest, net residential rents and capital gains (Recommendation 14).³ The aim of the latter was to improve a shortfall in housing supply by providing a more neutral personal income tax treatment of private residential rent.⁴

Outside the scope of this article, however, is a discussion on the Australian CGT rules with respect to the treatment for non-residents who dispose of taxable Australian property (Div 855 of the *Income Tax Assessment Act 1997*) and capital gains withholding where the contract price is equal to or exceeds AUD 2 million (now AUD 750,000). Furthermore, it is beyond the scope of this article to specifically consider cross-border issues,⁵ along with including discussion on the approaches to distinguishing between capital gains and ordinary income (other than briefly discussing the use of bright line tests). Another major CGT issue which is beyond the scope of this article is whether a CGT should apply to disposals of assets only or whether it should it extend to gains on the discharge of liabilities.

The remainder of the article is set out as follows. Section 2 discusses the key policy choices in relation to CGT. Section 3 then provides an historical analysis of New Zealand's approach to taxing capital gains along with failed attempts to introduce a comprehensive CGT regime. Section 4 follows with an analysis of Australia's CGT regime and provides an insight into some of the more controversial policy choices around the design of the CGT. The article concludes in section 5 by providing recommendations as to 'ideal' policy choices should a CGT be proposed as part of government tax policy for New Zealand.

2. CGT AND KEY POLICY CHOICES

Any proposal for the introduction of significant tax reform necessarily requires a consideration of the key policy choices that need to be carefully examined. The introduction of a CGT in New Zealand is no exception and, as such, this part of the article outlines those key policy considerations should a future government announce that it is working on a CGT. The analysis is undertaken within a comprehensive tax base

³ See Australia's Future Tax System Review Panel (Dr Ken Henry, chair), *Australia's Future Tax System: Report to the Treasurer* (December 2009) (Henry Review) Pt 1, xix.

⁴ Ibid xxiii.

⁵ In principle we are in favour of adopting the jurisdictional rules in the OECD Model Tax Convention on Income and on Capital (2017). However, indirect interests and the issues arising from the *Lamesa Holdings* case relating to the allocation of taxing rights under tax treaties to gains from transfers of shares in 'land-rich' entities (*Federal Commissioner of Taxation v Lamesa Holdings BV* [1997] FCA 785; 36 ATR 589) are important design issues requiring consideration in relation to a New Zealand CGT. See further on this case Kathrin Bain, Richard Krever and Anthony van der Westhuisen, 'The Influence of Alternative Model Tax Treaties on Australian Treaties' (2011) 26(1) *Australian Tax Forum* 31, 32-33.

framework which applies income tax to net economic gain, adjusted for inflation. The article then considers modifications to this 'ideal' framework based on the design principles of equity, efficiency, simplicity, sustainability and policy consistency.

2.1 Threshold considerations

As a starting point, countries often need to determine whether they wish to introduce a CGT at all and, as Evans points out, 'there is no real consensus as to what capital gains are or whether they should be taxed at all'.⁶ A review of different regimes suggests a lack of unifying principle⁷ and indicates that countries adopt numerous different approaches to the taxation of different forms of capital gains.⁸ As such, while nearly all OECD countries have a CGT, with New Zealand as the notable outlier, the implementation and operation of those regimes differs. Evans also suggests that there is no one and ideal way to tax capital gains.⁹ Each country considers its own reasons for introducing such a tax with 'fiscal equity' common, and other rationales such as 'widening the tax base, limiting income tax avoidance, improving vertical equity, and reducing investment distortion' also listed.¹⁰

The policy reasons for taxing capital gains are well-documented, with those same reasons providing the policy rationale for the design of a CGT regime. Justification for taxing capital gains generally lies in the concept of the comprehensive tax base, often considered the theoretical starting point to the design of an income tax regime.¹¹ The definition of the comprehensive tax base is generally accepted to be found in the Schanz-Haig-Simons framework which defines income as consumption plus changes in net wealth.¹² In 1938, Simons specifically defined personal income as 'the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question'.¹³ With capital gains falling within the second part of the definition, failure to tax those gains is considered to breach the underpinning design principle of equity as there is a distortion of investment decisions with returns in the form of gains being treated preferentially.¹⁴

Ultimately, economic theory provides an underlying rationale for taxing capital gains and the design of a system for doing so. However, no country strictly adheres to the

⁶ Chris Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?' (2002) 5(1) *Journal of Australian Taxation* 114, 114.

⁷ Chris Evans and Cedric Sandford, 'Capital Gains Tax – The Unprincipled Tax' [1995] 5 *British Tax Review* 387, 403.

⁸ For a comprehensive review of the approaches adopted by OECD countries, see OECD, *Taxation of Capital Gains of Individuals: Policy Considerations and Approaches*, Tax Policy Studies No 14 (OECD, 2006).

⁹ Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?', above n 6, 114.

¹⁰ Cooper and Evans, above n 1.

¹¹ For a comprehensive review of the influence on different and often competing theories on the taxation of capital, however, see David White, 'Personal Capital Gains Taxation: Reflections on the Influence of Economic Theory on Tax Reform Proposals' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 18.

¹² Robert M Haig, 'The Concept of Income – Economic and Legal Aspects' in Robert M Haig et al, *The Federal Income Tax* (Columbia University Press, 1921) 1-28; Henry Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (University of Chicago Press, 1938) 49.

¹³ Simons, above n 12, 50.

¹⁴ Chris Evans, John Minas and Youngdeok Lim, 'Taxing Personal Capital Gains in Australia: An Alternative Way Forward' (2015) 30(4) *Australian Tax Forum* 735, 738.

comprehensive tax base.¹⁵ In any current setting an 'ideal' model is modified to take into account the often competing imperatives of equity, efficiency, simplicity, sustainability and policy consistency. The five concepts, which we argue should be considered in the design of a CGT regime, formed the basis of recommendations contained in the report of the Australia's Future Tax System report of 2009 (known as the Henry Review after the chair of the Review Panel, then Treasury Secretary Dr Ken Henry) which was the most recent comprehensive review of Australia's tax regime. Arguably, this also takes us to the necessary consideration of optimal tax theory in which it is recognised that 'governments are trying to raise revenue in an economy that is inevitably distorted'.¹⁶

Ken Henry himself supported any move towards a comprehensive tax base despite recognising declining theoretical support for such an approach.¹⁷ Ultimately, Australia's approach is one which combines the comprehensive tax base model with optimal tax theory. While equity, efficiency and simplicity are considered traditional tax policy principles, the latter two reflect a modern recognition of the need to take into account the way taxes and transfers affect people's behaviour and the economy.¹⁸ As such, this article considers all five design factors.

2.2 Equity

Equity has long been considered the mainstay rationale for a CGT with both horizontal inequity and vertical inequity occurring without such a tax. Horizontal inequity occurs because individuals in similar circumstances may be treated differently where income is from capital gain compared to labour. Vertical inequity can also occur as it is generally higher wealth individuals who earn income from capital gains and benefit from a preferential regime. As such, when designing a CGT regime, policy-makers need to ask whether the proposed model treats individuals with similar economic capacity in the same way, while those with greater capacity bear a greater net burden. That is, is the overall system progressive?

2.3 Efficiency

Efficiency also needs to be considered, with policy-makers asking whether the proposed model raises and redistributes revenue at the least possible cost to economic efficiency and with minimal administration and compliance costs. Further, it is necessary to consider whether the system affects the choices people and businesses make by altering their incentives to work, save, invest or consume things of value to them. Efficiency is often considered to be breached without a CGT regime due to the distortions it potentially creates in investment decisions. As a general policy, it is argued that savings should be taxed as consistently as possible to minimise tax arbitrage opportunities. This avoids introducing bias into both 'household and investor decisions about what assets best suit their needs and preferences'.¹⁹

¹⁵ OECD, *Taxation of Capital Gains of Individuals*, above n 8.

¹⁶ White, above n 11, 32. For a discussion of the extent to which the Henry Review may involve a shift from a comprehensive tax base to optimal taxation approach, see also Richard Vann, 'Never-Ending Tax Reform and Financial Services' (2011) 14(4) *Tax Specialist* 186, 187.

¹⁷ Ken Henry, 'Towards a Better Taxation of Savings' (address to the Australian Conference of Economists Business Symposium, 1 October 2009), as cited by White, above n 11.

¹⁸ Henry Review, above n 3.

¹⁹ *Ibid* Pt 2, Vol 1, 64.

This second criterion of efficiency, however, is generally regarded as one which is hard to assess and is somewhat unclear in the argument for or against a CGT.²⁰ Efficiency will often only be addressed in a partial sense by introducing a CGT due to pragmatic considerations in the design of the tax as actually implemented in practice. As is discussed further in the context of Australia in section 4.2, in almost all instances, for example, there will be a deferral of liability to CGT on gains until realisation of those gains occurs rather than taxing the gains on an accruals basis. To take into account this deferral, most systems then also provide for an adjustment for inflation. There are several means for doing this including the original system in Australia of indexing elements of the cost base, or the current Australian system which provides for a discount for individuals and retirement savings funds and which was introduced as a notional alternative for indexation for assets acquired up to the date of the introduction of the discount. In some other instances, capital gains are taxed at a lower rate than other forms of income. There will also always be a bright-line boundary between ordinary income and capital gains which will provide an opportunity for 'gaming' by taxpayers with efficiency effects. In conclusion, however, policy-makers nonetheless must, within the context of a countries' priorities, consider the effects a CGT (or absence of a CGT) has on efficiency.

2.4 Simplicity

The third of the traditional criteria, simplicity, is seen as the most difficult to meet in regard to a CGT and it is generally a case of ensuring that any regime is not overly complex. While questions around simplicity are easy to ask, such as whether the system is easy to understand and simple to comply with and whether the system is transparent, a CGT regime is generally evaluated according to its complexity rather than as part of a general evaluation of simplicity, with policy considerations centred on reducing that complexity. As discussed in section 4.4 below, the greater the number of concessions and exemptions, the more complex a CGT regime will be. As noted in Australia's most recent comprehensive review of its tax system, 'principal drivers of the high administration and compliance costs include the complexity of the legislation, the frequency of changes to the legislation, the number of rules and exceptions, and record keeping requirements'.²¹

Notwithstanding these comments, the introduction of a CGT requires the will of the people and this in turn may mean that exemptions need to be part of the campaign to convince voters of such a tax. With these exemptions however, comes additional complexity and further costs imposed on taxpayers. As with all taxes, individuals are more likely to accept the introduction of an additional burden if they believe that it will be imposed on another taxpayer besides them. For example, if an individual believes that their property will be exempt from tax, they are more likely to support the introduction of a CGT.²² A fundamental difficulty with the introduction of a CGT is the

²⁰ Cooper and Evans, above n 1.

²¹ Henry Review, above n 3, Pt 2, Vol 1, 78.

²² This is largely due to that individual's likely assessment of receiving a relative tax advantage. See for example, the comment by Daniel Shaviro, in the context of tax simplification that '... [o]nce we get beyond slogans, however, [tax] simplification is a public good that few political actors value more than the opportunity to shift their own tax burdens to someone else'. Daniel Shaviro, 'Simplifying Assumptions: How Might the Politics of Consumption Tax Reform Affect (Impair) the End Product?' in John W Diamond and George R Zodrow (eds), *Fundamental Tax Reform: Issues, Choices, and Implications* (MIT Press,

fact that it is generally an extra tax which is not offset by a reduction or removal of another tax. Countries that have introduced a CGT have in general not provided a specific reduction in income tax as an offset for the increased taxes on gains, as occurred in the case of the GST in New Zealand in 1986. It can be noted, though, that Australia's September 1985 tax reform announcement which included the CGT also provided for a lowering of the top personal marginal income tax rate below 50 per cent from 1 July 1987, and this decade also saw substantial reductions in company tax rates²³ In overall terms, it has nevertheless been observed that '[t]ax reform is a *political exercise*'.²⁴

2.5 Sustainability

Sustainability is the first of the non-traditional criteria and requires a tax system to have the capacity to meet the changing revenue needs of government on an ongoing basis without recourse to inefficient taxes. A tax system is considered to be sustainable where it contributes to a fair and equitable society. Ultimately, a country needs to determine the mix that it wants in terms of taxes, that is, what balance will be required between taxes on income, capital, personal, business, land and resources. Revenue considerations of a capital gains tax will be significant, given that introduction of the tax on the gains will often, at least politically, require allowance to be made in some form for capital losses.

In addition, as explained in the Henry Review, 'legal and administrative institutions and frameworks should also be robust to maintain the effectiveness of the system and underpin the legitimacy of the system. Policy settings should also contribute to environmental outcomes that are sustainable'.²⁵

2.6 Policy consistency

Finally, a country needs to consider whether there is policy consistency throughout the whole of the tax regime. It cannot only consider the implications of a CGT regime in isolation, but also evaluate its internal consistency to see whether it contradicts any other part of the system and whether it is consistent with the broader policy objectives of the government.

2.7 Further considerations

Of course, factors which need to be taken into account and which influence the design of a CGT regime extend beyond these five core concepts. As White notes, 'key influences on future CGT reform other than current policy and practice include systems of political decision making, economic and technological change, ideology and, of course, ideas'.²⁶ In 2006, the OECD published a study it conducted asking countries to respond to a questionnaire about their CGT regime.²⁷ This study revealed five common

2008) 75, 124, as cited in Binh Tran-Nam, Chris Evans, Richard Krever and Philip Lignier, 'Managing Tax Complexity: The State of Play After Henry' (2016) 35(4) *Economic Papers* 347, 355.

²³ See 'Keating aims for tax honesty, New package designed to get respect back into the system, Tax cuts ahead, immediate crackdown on lurks, mild gains impost' *Canberra Times* (20 September 1985) 1.

²⁴ Geoffrey Brennan and Michael Brooks, 'The Henry Tax Review: A View from Constitutional Political Economy' in Chris Evans, Richard Krever and Peter Mellor (eds), *Australia's Future Tax System: The Prospects After Henry* (Thomson, 2010) 417, 417.

²⁵ Henry Review, above n 3, Pt 1, 17.

²⁶ White, above n 11, 20.

²⁷ OECD, *Taxation of Capital Gains of Individuals*, above n 8.

key considerations: securing tax revenues; efficiency considerations including 'lock-in effects; horizontal and vertical equity goals; encouraging savings and investment; and limiting taxpayer compliance and tax administration burdens.²⁸

Further compounding CGT regime design decisions is the fact that concepts compete with each other, more often than not failing to offer complementary benefits. To this end, in the context of a CGT regime, 'arguments about the inequity of not taxing capital gains have outweighed the potential inefficiencies and complexities that inevitably accompany the introduction of such a tax'.²⁹ As such, we argue that the primary consideration needs to be one of equity. As discussed above, failure to tax capital gains leads to both horizontal and vertical inequity. What is often overlooked, however, is the fact that equity is improved simply because a CGT regime operates to protect the integrity of the tax base. As explained by Cooper and Evans:³⁰

the rationale for taxing capital gains is to be found primarily in the improved equity that such a tax introduces to the tax system. Without a CGT the potential for avoidance is immense. ... A CGT protects the integrity of the income tax base by preventing leakage through dressing up or converting income to capital. In addition, the introduction of a CGT can lead to greater neutrality and efficiency in the tax system, though potentially at the cost of reduced simplicity.

Any proposal to introduce a CGT that is based on a 'revenue raising' objective may arguably be flawed. In relation to revenue raising, CGT regimes typically do not raise a lot of revenue but rather, they stem the leakage that would occur if there was no CGT regime. As such, a CGT regime operates as an integrity measure which protects the income base by preventing the re-characterisation of ordinary income into non-taxable capital gains. While revenue may be raised from the direct taxation of capital gains, it is the prevention of leakage and its effect on the integrity of the system as a whole that is perhaps the greatest benefit to the introduction of such a tax.³¹

Finally, as Krever and Brooks point out, there are characteristics of capital gains that make it technically difficult to tax these gains equitably, efficiently and simply.³² In particular, they point to the fact that it is difficult to delineate the boundaries of the concept, that they are not normally realised on an accruals basis, neutrality is difficult to achieve, and there is an income/consumption tax tension.³³ In addition to these technical difficulties, there are the obvious political considerations which Krever and Brooks suggest further complicate the issue as to whether and how to design a CGT regime. They summarise these considerations as being, first, the furthering of social and economic objectives which mean that gains should be taxed preferentially and, second, ideological considerations centred on the argument between a progressive system and one that already taxes 'the rich' unfairly.³⁴

²⁸ Ibid 31.

²⁹ Cooper and Evans, above n 1.

³⁰ Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?', above n 6, 121.

³¹ Ibid; Chris Evans, 'CGT – Mature Adult or Unruly Adolescent?' (2005) 20(2) *Australian Tax Forum* 291.

³² Richard Krever and Neil Brooks, *A Capital Gains Tax for New Zealand* (Victoria University Press for Institute of Policy Studies, 1990) 1.

³³ Ibid.

³⁴ Ibid.

For those who argue for the taxation of a comprehensive tax base, taxing all capital gains at marginal rates of tax results in the policy ideal.³⁵ Ultimately, however, the quest for an optimal tax structure which incorporates a CGT will inevitably involve trade-offs.³⁶ Optimal tax theory allows us to reconcile these trade-offs by combining traditional benchmark criteria to achieve a result which is the one that 'maximises social welfare, in which the choice between equity and efficiency best reflects society's attitudes toward these competing goals'.³⁷

This section has discussed the theoretical basis for a CGT regime. Before considering Australia's comprehensive CGT regime in further detail in section 4 and making some recommendations for New Zealand moving forward in section 5, we now turn to a review of New Zealand's approach to taxing capital gains over the years prior to considering Australia's comprehensive CGT regime.

3. NEW ZEALAND – CGT IN REVIEW

In this part of the article, we examine the history of the debate around New Zealand reforming its tax system to include a comprehensive CGT regime. New Zealand is currently recognised as an outlier within OECD countries for not having a separate CGT. However, as outlined here, it does tax a number of types of capital gains as ordinary income at the standard income tax rates. For example, if Inland Revenue believes a person is 'trading' in property or other investments for a living, the resulting capital gain is viewed as income from the property trading business and is taxed at the standard income tax rates.³⁸ Another common example is builders, developers and property dealers being required to pay tax on capital gains from properties held for less than 10 years.³⁹

Furthermore, numerous proposals for a CGT have been made by opposition parties as part of their policy platform but none of these parties have been successful in forming part of a government, and as such, their proposals have failed to come to fruition. The closest that New Zealand came to the introduction of a CGT was via the Tax Working Group (TWG) in 2009-10 through its recommendation as part of a portfolio of tax policy options.⁴⁰ Perhaps most significant, and certainly most recent, is the introduction of the bright-line test, introduced in 2015, which applies tax to the profits from the purchase and sale of residential property within two years of acquisition. The debate nevertheless continues over whether New Zealand should embrace a formal standalone CGT. Each of these attempts, along with the current limited regime is discussed below.

³⁵ Evans, Minas and Lim, 'Taxing Personal Capital Gains in Australia: An Alternative Way Forward', above n 14, 744.

³⁶ Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?', above n 6.

³⁷ Joseph Stiglitz, *Economics of the Public Sector* (Norton, 2nd ed, 1998) 478-479, as quoted by Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?', above n 6.

³⁸ See, for example, Inland Revenue, 'Property' in *Compliance Focus 2013-2014* (Wellington, 2013), available at:

<https://www.ird.govt.nz/aboutir/reports/compliance-focus/compliance-previous-years/compliance-focus-2013-14/other-focus-areas-13/property-13/>.

³⁹ See *Income Tax Act 2007* (NZ) ss CB 9 to CB 12.

⁴⁰ See Tax Working Group, *A Tax System for New Zealand's Future: Report of the Victoria University of Wellington Tax Working Group* (Centre for Accounting, Governance and Taxation Research, Victoria University of Wellington, 2010), available at:

<https://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/pdf/tax-report-website.pdf>.

3.1 The history of the CGT debate in New Zealand – early years through to 2009

In contrast to almost all other OECD countries, until recently, there has been very little discussion in New Zealand about the introduction of a CGT. Krever and Brooks, in their 1990 study on the New Zealand system, point out that when tax legislation was first passed in 1891, it was wide enough to incorporate a tax on capital but, like other Commonwealth courts, it was limited to the concept of income under trust law.⁴¹ They also note that none of the early reports on taxation in New Zealand dealt extensively with the taxation of capital gains.⁴²

While New Zealand did have an estate tax from the early years (ultimately repealed in 1999), later reviews increasingly began to focus on the capital gains tax issue itself. The taxation of capital gains was considered by the Ross Committee in their 1967 Report and in 1982 by the McCaw Committee in their 1982 Report,⁴³ while the sizeable report prepared by the Royal Commission on Social Policy in 1988 also extended to consideration of tax issues.⁴⁴ As in Australia at the time, targeted taxation measures were enacted in the 1970s and 1980s to address speculative excesses and perceived unfairness, such as New Zealand's property speculation tax of 1973 and the Muldoon government's measure in 1982 to recoup the amount of interest deductions previously enjoyed by a taxpayer by a tax on the sale of a property and held for less than ten years.⁴⁵ These measures inevitably met severe political resistance during their periods of operation which led to their repeal. Similarly, a significant debate in New Zealand at the time of Australia's introduction of the CGT in the mid-1980s led to the contrasting outcome in New Zealand of 'deferral' and eventual abandonment of the proposals at that time. More lasting reforms were also achieved, however, in relation to specific measures to tax (or codify and strengthen the existing rules for taxation of) various transactions involving land, such as land acquired for the purpose or with the intention of disposal, as part of a business relating to land or a land dealing or development business and so forth.⁴⁶

By 2001, the CGT issue returned to prominence with the consideration of the measure by the McLeod Committee, which concluded in its Final Report:⁴⁷

⁴¹ Krever and Brooks, above n 32, 36.

⁴² Ibid.

⁴³ See Taxation Review Committee (L N Ross, chair), *Taxation in New Zealand: Report of the Taxation Review Committee* (Government Printer, 1967) (Ross Committee); Task Force on Tax Reform (Peter McCaw, chair), *Task Force on Tax Reform: Final Report* (Government Printer, 1982). See also Melinda Jacomb, 'A History of Taxing Capital Gains in New Zealand: Why Don't We?' (2014) 20 *Auckland University Law Review* 124, 132-135.

⁴⁴ The Royal Commission on Social Policy (Justice Ivor Richardson, chair), *The April Report: Report of the Royal Commission on Social Policy* (Government Printer, 1988).

⁴⁵ See further Robert Vosslander, "Removing a Parasitic Element": Speculation, Housing Affordability and the 1973 Property Speculation Tax' (2015) 21(2) *New Zealand Journal of Taxation Law and Policy* 169; Robert Vosslander, 'What Looks Like a PST and Smells Like a PST...?' (2016) 22(2) *New Zealand Journal of Taxation Law and Policy* 106.

⁴⁶ See now ITA 2007 ss CB 6A to 15B. These measures include provisions to extend liability to associates which are seen by some as harsh.

⁴⁷ Tax Review 2001 (Robert McLeod, chair), *Final Report* (Government Printer, October 2001) (McLeod Review) 28, para 3.14, available at:

<http://www.treasury.govt.nz/publications/reviews-consultation/taxreview2001/taxreview2001-report.pdf>.

... nothing ... has altered our view ... that New Zealand should not adopt a general realisation-based capital gains tax. We believe that such a tax would not necessarily make our tax system fairer and more efficient, would not lower tax avoidance and would not raise substantial revenue that could be used to lower tax rates. Instead, any such tax would be more likely to increase the complexity and costs of our system. The experience of other countries (such as Australia, the UK and the US) supports that conclusion.

The McLeod Committee proposed the taxation of a number of types of gains using a standard risk-free rate of return method (RFRRM), no matter the country of investment. This formed part of an issues paper released by the McLeod Committee on 20 June 2001, leading to a second round of consultations.⁴⁸ Public resistance to the application of the RFRRM on private housing led to this proposal not being included in the McLeod Committee's Final Report. However, the Minister of Revenue at the time (Dr Cullen) was interested in the RFRRM for an aspect of international taxation, on the basis that in his view it had the potential to make the relevant tax rules simpler, fairer and more effective. Dr Cullen indicated that the government would examine the Foreign Investment Fund (FIF) regime in this regard. A form of capital gains tax was introduced as the fair dividend rate. In this context, New Zealand has very specific forms of taxation of capital gains in its foreign investment fund (FIF) rules and the financial arrangement rules which had been introduced in 1986 and applied tax to gains from the holding of debt instruments among other provisions.

In summary, in 1990, Krever and Brooks pointed out that a consensus was developing in New Zealand among tax analysts that the failure to tax capital gains was a fundamental structural flaw in the New Zealand tax system.⁴⁹ As such, it is academics who have been significant contributors to the CGT debate in New Zealand. A review of their contributions since 2000 reveals a common theme of studying the experiences of overseas jurisdictions to learn from mistakes, as well as best practice. In this regard, a suggested acknowledgement that New Zealand is unique in its situation as a justification for not implementing a CGT has been put forward by policy-makers unwilling to make what is potentially seen as a tough decision to recommend a CGT for New Zealand. Even the major contributions of the Tax Working Group in 2009-10 and the outputs from more recent policy debates have failed to find a political champion for a CGT, unlike Roger Douglas and the GST in 1984.⁵⁰ The lack of any sort of 'political champion' has meant that the substantive contribution to the debate has been led by academics. Below, we summarise a number of the early contributions to the CGT debate in New Zealand.

Kenny concludes:⁵¹

In line with the general international trend towards comprehensive income tax bases the case for a CGT in New Zealand is very strong. ... Given the convergence of at least three of the tax policy criteria: efficiency, adequacy,

⁴⁸ McLeod Review, *Issues Paper* (Government Printer, June 2001).

⁴⁹ Krever and Brooks, above n 32, 36.

⁵⁰ See, for example, the discussion on this topic in Adrian Sawyer, 'New Zealand's Successful Experience Introducing GST: Informative Guidance for Hong Kong?' (2013) 43(1) *Hong Kong Law Journal* 161.

⁵¹ Paul Kenny, 'Capital Gains Taxation for New Zealand: Fairer and More Efficient' (2001) 7(4) *New Zealand Journal of Taxation Law and Policy* 265, 290 (emphasis added).

and equity, *the case for the introduction of a comprehensive capital gains tax in New Zealand is compelling.*

Burman and White observe:⁵²

There is no perfect way to tax capital gains in a real-world income tax. Not taxing them, or *taxing them in an ad hoc and inconsistent fashion as is done in New Zealand invites unproductive tax avoidance, creates uncertainty for taxpayers, and is inequitable.*

Elliffe and Huang observe that New Zealand is unique, concluding:⁵³

The reason historically that New Zealand does not have a CGT is not because *New Zealand policymakers fail to recognise the benefits of such a form of taxation, but because they have been overawed by the perceived problems and cost associated with it.*

In looking at the history of this tax policy, it is possible to conclude that the rejection is primarily due to unsubstantiated assertions that the law will become too complex from an administrative and technical perspective, and, bearing this burden in mind, is not worth the trouble from the revenue-collection perspective. ...

One of the advantages of being the last to adopt something is that you can learn from others' mistakes. Doing so, New Zealand could design a realised CGT which improves the tax system's equity, is administratively less complicated than other CGT systems, provides the tax administration with information, protects the integrity of existing rules, and still collects a realistic amount of revenue. ... It seems logical to assume that *New Zealand can learn something from other countries' mistakes, and, even in some cases, successes.*

Coleman undertakes a modelling analysis of a potential CGT in the long term in New Zealand on housing market.⁵⁴ He finds that based on the assumptions of the modelling there will be different results. Specifically, the model which uses an overlapping generations framework to model the housing demands of participants, suggests a CGT will raise rents, increase homeownership rates, promote smaller houses, and increase the net foreign asset position. The welfare implications are less clear.

3.2 Tax Working Group – 2009-10

In 2009, following a conference held at Victoria University of Wellington, it was determined that an independent group, known as the Tax Working Group (TWG), should be established. The TWG, comprising experts from academia, Inland Revenue, the Treasury, and from tax practice, were tasked to undertake a review of the New Zealand tax system from a policy perspective. The TWG undertook widespread

⁵² Leonard Burman and David White, 'Taxing Capital Gains in New Zealand' (2003) 9(3) *New Zealand Journal of Taxation Law and Policy* 355, 385 (emphasis added).

⁵³ Chye-Ching Huang and Craig Elliffe, 'Is New Zealand Smarter than Other Countries or Simply Special? Reconsidering a Realisation-based Capital Gains Tax in the Light of South Africa's Experience' (2010) 16(3) *New Zealand Journal of Taxation Law and Policy* 269, 304-305 (emphasis added).

⁵⁴ Andrew Coleman, 'The Long-Term Effects of Capital Gains Taxes in New Zealand' (2010) 44(2) *New Zealand Economic Papers* 159.

consultation and extensive reporting to the New Zealand Government, which resulted in a series of recommended options for major tax policy reform. Specifically the TWG sought to:

1. Identify concerns with the current taxation system;
2. Describe what a good tax system should be like;
3. Consider options for reform; and
4. Evaluate the pros and cons of these options.⁵⁵

During the third session of analysis, a realisation-based CGT for New Zealand was one of the major reform options open for discussion, along with a land tax and other forms of revenue raising from broadening the tax base. Burman and White provided arguments in favour of a CGT as a mechanism to improve efficiency, raise revenue, be progressive in its impact and assist with reduce taxes in other areas.⁵⁶ Inland Revenue and the Treasury were cautiously supportive in their submissions of a 'real-world' CGT that balanced theory with practical issues for New Zealand.

In its 2010 Report, the TWG concluded that New Zealand's tax system faced three critical issues:

1. Its structure was inappropriate;
2. It lacked coherence, integrity and fairness; and
3. Significant risks to the sustainability of the tax revenue base existed.

The TWG concluded in its 2010 report:⁵⁷

The most comprehensive option for base-broadening with respect to the taxation of capital is to introduce a comprehensive capital gains tax (CGT). While some view this as a viable option for base-broadening, *most members of the TWG have significant concerns over the practical challenges arising from a comprehensive CGT and the potential distortions and other efficiency implications that may arise from a partial CGT.*

This statement effectively 'hammered the nail into the coffin' for any further serious consideration of a CGT by officials and the New Zealand Government for the medium term. Creedy, in his review of the work of the TWG, offers considerable praise in commending the report to be read, concluding:⁵⁸

As mentioned earlier, the *strength of the report is in its attempt to contribute to rational policy debate by rehearsing the various arguments in a clear dispassionate manner, so that those on different sides of the debate can come*

⁵⁵ Tax Working Group, *A Tax System for New Zealand's Future*, above n 40, 19.

⁵⁶ Leonard Burman and David White, 'Taxing Capital Gains in New Zealand: Assessment and Recommendations' (Paper presented to the Tax Working Group, 2009).

⁵⁷ Tax Working Group, *A Tax System for New Zealand's Future*, above n 40, 11 (emphasis added).

⁵⁸ John Creedy, 'Reflections on "A Tax System for New Zealand's Future"' (2010) 17(1) *Agenda: A Journal of Policy Analysis and Reform* 63, 72 (emphasis added).

to understand just why they differ. That a disparate group of individuals from a range of backgrounds have established some common ground in a way of thinking about taxes is itself sufficient cause for praise. The Report can be read with interest and profit by all those interested in tax policy.

3.3 Bright-line test - 2015

Subsequent to the TWG report, there was little discussion on the introduction of a CGT for New Zealand. It was not until five years later that legislation was passed to introduce a very limited CGT for certain property – effectively what is considered another ‘pseudo’ CGT system. The bright-line test for determining the taxation of certain land sales came into effect on 1 October 2015.⁵⁹ Essentially, the gains from the disposal of residential land acquired and disposed of within two years will be taxable, subject to some exceptions.⁶⁰ The two-year bright-line period generally starts at the point a person has title for the property transferred to them and ends at the time the person enters into a contract to sell the property. There are specific rules for situations involving sales ‘off the plan’, where the two-year period runs from the date the person enters into a contract to buy the property to the time when a person enters into a contract to sell the property.

The bright-line test applies only to residential land where residential land is defined for these purposes to include: land that has a dwelling on it; land where the owner has an arrangement to build a dwelling on it; and bare land that can have a dwelling erected on it under the relevant district plan.⁶¹ Exceptions to the bright-line test provide that residential land does not include business premises or farmland. Furthermore, the bright-line test does not apply to a person’s main home. However, a person can only have one main home, so if they have more than one home, their main home is the one with which the person has the greatest connection. Special rules also apply to properties held in trust. The bright-line test also does not apply to property acquired through an inheritance and rollover relief is provided for property transferred as a result of a relationship property agreement. This means that any potential tax liability will be deferred until a subsequent sale.

Where property comes within the bright-line test, taxpayers will be allowed deductions for such property according to ordinary tax rules. These deductions can be offset against the income. However, losses arising from the bright-line test will be ring-fenced (quarantined) so that they may only be used to offset taxable gains from other land sales. There are specific anti-avoidance rules, in addition to the general anti-avoidance rule in s BG 1 of the *Income Tax Act 2007*, to counter companies and trusts being used to circumvent the bright-line test.

⁵⁹ For a useful overview, see Inland Revenue, ‘Taxation (Bright-line Test for Residential Land) Act 2015’ (2016) 28(1) *Tax Information Bulletin* 78.

⁶⁰ See *Income Tax Act 2007* s CB 6A. The period was extended to five years for agreements to purchase residential property entered into on or after 29 March 2018.

⁶¹ See Inland Revenue, ‘Bright-line test for residential land’, special report, Policy and Strategy, Inland Revenue (November 2015), <https://taxpolicy.ird.govt.nz/sites/default/files/2015-sr-bright-line-test.pdf>.

In an early appraisal of the bright-line test, Reid and Tan review New Zealand's history with respect to CGT, and examine how the bright-line test fits within this. They conclude:⁶²

Finally, it is clear that the Government, past and present, is not in favour of introducing a comprehensive capital gains tax as it is believed that it would not produce the desired outcome. Until now, a pseudo capital gains tax system has always emerged as the preferred option in New Zealand, and the introduction of a bright-line test for the sale of residential property is the latest addition to this pseudo system. *One day, when the tax system reaches a point where there are too many pseudo capital gains taxing regimes in place, then perhaps the Government will concede that a comprehensive capital gains tax is indeed essential.*

More recently, Cassidy and Cheng assert that the bright-line test has specifically targeted Chinese nationals. They conclude:⁶³

Section CB 6A of the ITA 2007 provides a new source of taxation for property gains made by Chinese nationals and the new RLWT ensures that tax is collected at settlement on the sale of properties by such persons. However, the focus of this article has been the impact of these reforms on Chinese 'offshore persons' and 'offshore RWT persons' and the sharing of the information gathered through these measures amongst governmental agencies, specifically Chinese tax authorities. The new Land Transfer Tax Statement and [sic] that provides the conveyancer related changes in the requirements for obtaining an IRD number will significantly impact on Chinese nationals. Similarly, the RLWT measures include disclosure requirements by both the vendor and the paying agent. *The use of such information by IRD and, in turn, the sharing of such with Chinese tax authorities will ensure greater compliance in both jurisdictions.* As discussed earlier, it will also address the significant money laundering that is currently occurring in New Zealand.

The assertions by Cassidy and Cheng about the provisions being aimed at specific potential taxpayers cannot be conclusively established, however, and the bright-line test on its terms applies to all vendors of land whether resident or non-resident. The information requirements can also be considered both necessary and entirely conventional, fulfilling the role that stamp duty regimes fulfil in other jurisdictions (and which New Zealand does not have).⁶⁴

⁶² Ian Reid and Lin Mei Tan, 'The Bright-Line Test on Residential Property Sales: Another Pseudo Capital Gains Tax Regime?' (2016) 22(2) *New Zealand Journal of Taxation Law and Policy* 157, 171 (emphasis added).

⁶³ Julie Cassidy, and Man Hung Alvin Cheng, 'The "Bright-line" Measures: The Tax Implications for China' (2017) 27(1) *Asia Pacific Law Review* 17, 27-28 (emphasis added).

⁶⁴ Furthermore, as a result of the money laundering concerns referred to by Cassidy and Cheng, New Zealand's foreign trust tax regime has recently undergone significant change recently following the Shewan review and the information requirements under the bright line regime mirror the requirements now imposed on New Zealand trustees of trusts settled by non-residents in New Zealand: see further, Government Inquiry into Foreign Trust Disclosure Rules (John Shewan, chair), *Report of the Government Inquiry into Foreign Trust Disclosure Rules* (New Zealand Government, June 2016).

Most recently, Tsen, Singh-Ladhar and Davey undertook a survey of practitioners and other tax professionals as to their views on the bright-line test. They conclude:⁶⁵

Concern regarding the bright-line test is well founded and the authors note that the similar opinions from participants should be an indication that further policy consultation and development is required – perhaps forming the basis for further research regarding the types of additional policy tools that could be used to integrate new tax rules into the statute books. However, it is accepted that the bright-line test will likely aid the Inland Revenue Department in some way – even if to reduce some level of compliance and administration costs so that their limited resources can be used elsewhere.

With the setting up of the new Government in late 2017, it has delivered on its promise with an extension of the bright-line test period from the current two years to five years, with effect from 29 March 2018.⁶⁶ The result of this extension is that the provisions now tax medium-term gains rather than short-term gains as they did originally. Concerns have also been raised around the limited exemptions which are viewed as being not nearly as generous as the Australian 50 per cent concession for individuals.

The initial two-year period for the bright-line test resulted in a question around whether the provisions imposed a form of capital gains tax or ordinary income tax. It is well established that real estate purchased for the purpose or intention of subsequent disposal is already taxable as income and the introduction of bright-line test merely provided an objective rule to the purpose/intention test contained in the provisions. However, the extension to five years suggests that the provision now operates in a way more akin to a true capital gains tax.

3.4 Current debate (post-Tax Working Group)

Post the TWG, Barrett and Veal look at the CGT debate through the manner in which it has been portrayed in the media, observing that the broadly accepted theoretical reasons for countering the judicial distinction drawn in income tax jurisprudence between capital and revenue were not adequately explained. In this regard, the challenge is for tax academics to play a greater role in engaging with the public through simplifying the arguments and working with the media.⁶⁷

During the 2011 General Election campaign, the New Zealand Labour Party had a CGT as part of its manifesto. Maples reviews the CGT proposal, offering compliments on the

⁶⁵ Lydia Tsen, Jagdeep Singh-Ladhar and Howard Davey, 'Is the Future Too Bright? An Empirical Investigation of Whether the Bright-line Test is Sound Tax Policy' (2017) 23(3) *New Zealand Journal of Taxation Law and Policy* 331, 349 (emphasis added).

⁶⁶ See further Inland Revenue, 'Tax bill passes third reading', media statement relating to the Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill (subsequently assented to on 29 March 2018), <http://taxpolicy.ird.govt.nz/news/2018-03-28-tax-bill-passes-third-reading>.

⁶⁷ Jonathan Barrett and John Veal, 'Equity versus Political Suicide: Framing the Capital Gains Tax Debate in the New Zealand Print Media' (2013) 19(2) *New Zealand Journal of Taxation Law and Policy* 91.

quality of the work done. However, he cautions that the focus must be on maintaining clear policy:⁶⁸

The success of a CGT, or any tax, will depend on a clear policy rationale which informs the design, consultation and implementation phases. A failure to clearly articulate its purpose and adhere to it will potentially lead to a poorly designed and functioning CGT. Further, policymakers can expect to face heavy lobbying with any such future tax. Keeping a clear focus of the object(s) of the tax will ensure that pressure from lobby groups do not derail the tax.

The 2011 Labour Party CGT proposal contained some similar features to the existing Australian regime, such as the small business retirement concessions, but in contrast to Australia made only quite limited provision for relief for capital assets already owned. Transitional provisions, as Maples points out, are always a difficult issue to deal with and Australia is unique in terms of its 'grandfathering' of what are known as 'pre-CGT' assets. The proposal arguably also did not adequately address the potential contradiction involved in seeking to address housing affordability concerns in the situation where Australia and other jurisdictions nevertheless have similar or greater housing affordability problems even with their CGT regimes in place (though whether those problems would be worse without the CGT remains an open question).

The most recent major contribution to the debate is a special issue of articles in the *New Zealand Journal of Taxation Law and Policy* in 2015.⁶⁹ The articles largely come from a conference held in 2014 that were part of a wider examination of the key issues involved in the design of CGT regimes.⁷⁰ It was intended to inform the debate, not promote the introduction of a CGT. In their editorial, Elliffe and Littlewood comment that the key issues discussed include:⁷¹

- Whether the CGT should be integrated as part of the income tax provisions or a separate stand-alone tax;

⁶⁸ Andrew J Maples, 'A Comprehensive Capital Gains Tax in New Zealand – No Longer Political Hari-Kari?: A Consideration of the Labour Party Proposal of 2011' (2014) 20(2) *New Zealand Journal of Taxation Law and Policy* 144, 167 (emphasis added).

⁶⁹ The articles included in this Special Issue are: Peter Vial, 'New Zealand's Tax Base "Kumara"' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 14; David White, 'Personal Capital Gains Taxation: Reflections on the Influence of Economic theory on Tax Reform Proposals' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 18; Shelley Griffiths, "'The Game is Not Worth the Candle": Exploring the Lack of a Comprehensive Capital Gains Tax in New Zealand' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 51; Jacob Spoonley, 'A Sanctuary from the Taxman?: The Design of the Primary Residence Exemption' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 69; Craig Elliffe, 'Key Issues in the Design of Capital Gains Tax Regimes: Taxing Non-Residents', (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 90; Shaleshni Sharma and Howard Davey 'Characteristics of a Preferred Capital Gains Tax Regime in New Zealand' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 113, and Aaron Quintal, David Snell and Nicholas Chan, 'Key Issues in the Design of Capital Gains Tax Regimes: The Impact on Tax Practice' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 137.

⁷⁰ Additional papers have recently been published in a book: Michael Littlewood and Craig Elliffe (eds), *Capital Gains Taxation: A Comparative Analysis of Key Issues* (Edward Elgar, 2017).

⁷¹ Craig Elliffe and Michael Littlewood, 'Editorial' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 11.

- How to introduce such a tax (only in respect of assets acquired after the implementation date or in respect of gains occurring after implementation on any asset held at the implementation date)?
- Whether the rate of tax on capital gains should be similar to the rate of tax on income or lower?
- Whether capital losses should be available to offset against ordinary income or only capital income?
- Whether we should tax non-residents on a less comprehensive basis than residents? and
- What exemptions should be available (personal residence and rollover relief for businesses and farms), how should they be structured (should they be unlimited or capped at a dollar value), and when should they be available (in respect of each transaction or upon death)?

Elliffe and Littlewood conclude:⁷²

New Zealand is a small and open economy. *While the experience of overseas jurisdictions in dealing with difficult and significant tax and economic matters can be extremely helpful to New Zealand policymakers in their attempt to create the best settings for a vibrant and successful New Zealand society, it is also necessary to focus on New Zealand specific issues in order to create the best outcome.*

Needless to say, Australia's CGT is not the only model for New Zealand to consider. Recently, James and Maples, in using the UK's CGT as the basis of a model for developing a CGT for New Zealand, conclude:⁷³

As a late adopter of a CGT it has the advantage that it can look to the practices of other jurisdictions including the pragmatic approach of the UK. Two related lessons can be drawn from the UK experience. First, tax policy, principles and tax administration all have an important role in the design, reform and operation of CGT. Second, it is not easy to separate each aspect with regard to each individual feature of the UK CGT. Often all three dimensions are involved and sometimes in more than one way. The relationship between the three is therefore a close and complex one and trade-offs are required. With respect to the NZ proposals, *the UK experience is that all three dimensions (tax policy, tax principles and tax administration) should all be carefully considered.* In addition, as the UK experience demonstrates, *a successful tax policy also has to take account of political realities.*

⁷² Ibid 13 (emphasis added).

⁷³ Simon James and Andrew Maples, 'The Relationship Between Principles and Policy in Tax Administration: Lessons from the United Kingdom Capital Gains Tax Regime with Particular Reference to a Proposal for a Capital Gains Tax for New Zealand' (2016) 14(2) *eJournal of Tax Research* 455, 485 (emphasis added).

Most recently, Evans and Krever have laid the ground work should New Zealand decide to formally develop policy for implementing a CGT. They conclude:⁷⁴

New Zealand enjoys an enviable reputation for the range and quality of many aspects of its tax policy process, legislative provisions and administrative systems. Much of the innovation is based upon its status as a “first mover” in tax (and other) matters. *Ironically, it is a “last mover” so far as CGT is concerned, but that may not be such a bad thing. It certainly enables New Zealand to seek out world’s best practice and also to learn from other countries’ mistakes.* South Africa - when it introduced its CGT in 2001 - clearly benefited from a careful analysis of the CGT issues and problems that beset countries like the United Kingdom (1965), Canada (1972) and Australia (1985) when they introduced their regimes. As such, its regime probably combines the best features of those other countries, customised for local conditions.

The September 2017 General Election has now also come and gone. In the lead-up to the General Election, only one of the major political parties formally proposed a CGT for New Zealand. The Green Party has called for a CGT on all residential properties, except for the family home.⁷⁵ The Labour Party did not pursue its 2011 plan for a CGT at the 2017 General Election.

On 19 October 2017, it was announced that the next government would be a formal coalition between the Labour Party and NZ First Party, with a confidence and supply agreement between the Labour Party and the Green Party. In forming the new Government, the possibility of a CGT for New Zealand came a little closer. While the Labour Party initially left open the possibility of a capital gains tax,⁷⁶ the Government tasked the TWG with devising proposals for reform which would be taken to the next General Election in 2020 for the electorate to endorse (assuming that Labour was able to form another Government).

No formal statement has emerged as yet with respect to whether a CGT is on the government's agenda; this is in spite of the release of Government TWG's interim report in September 2018.⁷⁷ The Government TWG in its interim report sets out two potential options for extending capital income taxation in New Zealand. These are extending the tax net to include gains on assets that are not already taxed, and taxing deemed returns from certain assets (known as the risk-free rate of return method of taxation). Feedback

⁷⁴ Chris Evans and Richard Krever, 'Taxing Capital Gains: A Comparative Analysis and Lessons for New Zealand' (2017) 23(4) *New Zealand Journal of Taxation Law and Policy* 486, 509 (footnotes omitted, emphasis added).

⁷⁵ See Green Party, *Economic Policy – Smart, Resilient and Fair* (2014) 13, available at: <https://www.greens.org.nz/page/economic-policy>.

⁷⁶ See Dan Satherly, 'Capital gains tax only for “select group of fortunate New Zealanders” – Davis', *Newshub.co.nz* (8 September 2017), <https://www.newshub.co.nz/home/election/2017/09/capital-gains-tax-only-for-select-group-of-fortunate-new-zealanders-davis.html>. The Labour Party's support for a capital gains tax at the 2014 General Election was apparently dropped as an explicit policy in favour of a TWG review of the matter following a change of Labour leadership in 2015: see Patrick Smellie, 'Tax an NZ election issue' *Acuity* (19 September 2017), available at: <https://www.acuitymag.com/business/capital-gains-tax-shapes-up-as-nz-election-issue> (accessed 31 January 2019).

⁷⁷ Tax Working Group, *Future of Tax: Interim Report* (New Zealand Government, September 2018), available at: <https://taxworkinggroup.govt.nz/resources/future-tax-interim-report>.

on these options from the public is intended to inform the recommendations in the Government TWG's final report in February 2019.

It would appear that the government still intends to seek a mandate for a CGT from the 2020 General Election. Individuals appointed to the Government TWG, such as Professor Craig Elliffe, are well known advocates of the capital gains tax. When the TWG was first set up, restrictions were placed on its advisory ability with such matter as taxes on family homes being off the table. No doubt, from a political perspective, capital gains exemptions for owner-occupied property is necessary, however the directive went beyond merely a capital gains tax to prevent any discussion on a broad based land tax such as that proposed in 2010.

The previous coalition government, prior to the 2017 General Election, continued to maintain its opposition to a CGT. Thus, overall the notion of a CGT remains highly politically sensitive. As discussed earlier, the new Government has delivered on one of its promises with an extension of the bright-line test period from the current two years to five years, with effect from 29 March 2018.⁷⁸ It should also be noted that the above discussion has focused on specific legislative reform proposals put forward by governments, and has not considered the underlying process of judicial interpretation of the capital-revenue boundary (and the apparent lack of political response to shifts in that boundary⁷⁹).

4. AUSTRALIA – CGT IN REVIEW

The discussion in section 2 above considered the key policy considerations any country may take into account to determine whether to introduce a CGT regime and what that regime might look like. It then noted that the failure of any sort of comprehensive CGT in New Zealand tends to stem from a failure of a clear policy rationale or a misunderstanding of what that rationale should be. It is also noted however that while theoretical considerations can be applied broadly, each country will have different imperatives. The historical and current debate in New Zealand, discussed in section 3 above, suggests that the taxing of capital gains is an ongoing political issue and a CGT is likely to be introduced at some time in the future, with numerous issues already having been raised.

As such, having considered appropriate policy rationale and principles, this article now turns to the various pragmatic considerations New Zealand will arguably face in the future in determining the form of CGT provisions it adopts, by a comparison with the experience in Australia with introduction of its model in the mid-1980s. While general theoretical and tax policy considerations need to be taken into account, pragmatic difficulties, as evidenced by existing regimes, also assist New Zealand in this process. Given the parallels New Zealand has with Australia, including not only similar economic conditions but similar tax regimes, much of this analysis will be drawn from that experience.

⁷⁸ See further Inland Revenue, 'Tax bill passes third reading', above n 66.

⁷⁹ See, for example, *Commissioner of Inland Revenue v Rangatira Limited* (1995) 17 NZTC 12,182 (CA). The Privy Council eventually decided the case (in the taxpayer's favour) on procedural grounds but left the Court of Appeal's findings on the tests for assessability of gains by an investment business otherwise intact; see *Rangatira Limited v Commissioner of Inland Revenue* [1996] NZPC 7; [1996] UKPC 54.

Australia has had a CGT regime in place since 1985, with the regime going through several amendments in the intervening years. In particular, concepts such as the grandfathering of pre-CGT assets, along with Australia's politically controversial exemptions and concessions, are considered. Further, the rationale for the replacement of the indexation of the cost base nearly two decades ago with the 50 per cent discount is of particular relevance to this discussion, as is the most recent debate around the perceived generous nature of this discount. Prior to a discussion on the current contentious issues in Australia's CGT regime, a short history is provided.

4.1 History of Australia's CGT regime

Australia's history concerning a CGT differs significantly from that of New Zealand. It introduced a comprehensive CGT regime in 1985. Prior to this date, there was limited taxation of capital gains in the form of two provisions: section 26(a) of the *Income Tax Assessment Act 1936* (later section 25A of that Act and ultimately section 15-15 of the *Income Tax Assessment Act 1997*) and section 26AAA (ultimately repealed in 1994) of the *Income Tax Assessment Act 1936*. The former, relying on a determination of the taxpayer's intent, included in the assessable income of a taxpayer profits arising from the sale of property acquired for the purposes of profit-making by sale or the carrying on or carrying out of any profit-making undertaking or scheme. The latter taxed short-term capital gains by including in assessable income of a taxpayer the profit on the sale of property held for less than 12 months. Neither provision proved successful as they could be easily manipulated.

In 1974, the Asprey Committee⁸⁰ recommended the introduction of a CGT in Australia but ultimately this was dropped by the Federal Government in 1975. It was not until ten years later, in 1985, that a CGT was once again recommended.⁸¹ A Draft White Paper was released by the government of the day on 4 June 1985 and the CGT regime was officially announced on 19 September 1985 as part of the *Reform of the Australian Tax System*⁸² and became effective as at that date. As such, Australia has had a comprehensive CGT regime from 20 September 1985. Like most regimes which tax capital gains, it taxes gains on a realisation basis with capital losses quarantined against any gains and able to be carried forward indefinitely. Assets acquired before that date are grandfathered and known as pre-CGT assets.⁸³ The original regime allowed an indexation adjustment to the cost base to take into account inflation where the assets was held for more than 12 months and there was a capital gain. However, indexation and averaging was abolished from 20 September 1999, and replaced with a 50 per cent discount for individuals where assets are held for more than 12 months.

Early changes to Australia's CGT regime came about after it became clear in the early 1990s that the original provisions in Part IIIA of the *Income Tax Assessment Act 1936* were not working well.⁸⁴ In particular, they were viewed as being unnecessarily

⁸⁰ Taxation Review Committee (Australia) (Justice Kenneth Asprey, chair), *Full Report* (Australian Government Publishing Service, 31 January 1975).

⁸¹ Australian Treasury, *Reform of the Australian Tax System: Draft White Paper* (Canberra, 1985).

⁸² *Ibid.*

⁸³ In contrast to the original enacting legislation for the Australian CGT regime, there is now no single rule supporting this statement; rather, it is refracted through the different CGT events, for example *Income Tax Assessment Act 1997* (Cth) s 104-10(5)(a) (CGT Event A1). See, by contrast, *Income Tax Assessment Amendment (Capital Gains) Act 1986* (Cth) s 19, enacting s 160L of the *Income Tax Assessment Act 1936*.

⁸⁴ Cooper and Evans, above n 1.

complex in both their presentation and expression.⁸⁵ At that time, the legislation was rewritten to remove deeming provisions which attempted to fit certain transactions into the requirement for the disposal of an asset and replaced the triggering event with what is known as 'CGT events'. The rationale behind this change was to make the provisions more accessible and more flexible and to provide a logical and coherent structure.⁸⁶ The current provisions are contained in Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997*.⁸⁷ Ultimately, the rewrite, designed to be merely technical in nature rather than a changing policy, has also been viewed as a failure as have the two subsequent reviews, the Ralph Review⁸⁸ and the Henry Review,⁸⁹ both of which provided the opportunity for government to undertake substantive reform to the CGT regime. Neither opportunity however was embraced.⁹⁰ As such, as Evans and Cooper explain, 'consequently we are left with a CGT regime that is more complex than most of its overseas counterparts. Just why it became so complex can, in part, best be explained by reference to the reasons that underlie its initial introduction and subsequent development'.⁹¹ Many of these reasons are outlined below in the context of discussion of the issues that Australia has faced and then of the policy determinations that New Zealand will have to make. In particular, we look at three areas which have proved controversial in Australia: the 'grandfathering' of certain CGT assets, indexation versus discount, and exemptions and concessions.⁹²

4.2 Timing issues and a 'grandfather' clause

The introduction of a CGT immediately raises questions about retrospectivity. That is, should the tax apply to all transactions or only those transactions which involve the disposal of an asset which was acquired after the introduction of the legislation? Australia is no exception to this debate but now stands out as adopting a unique position of 'grandfathering' certain CGT assets.⁹³ In fact, one of the most controversial debates around the introduction of a CGT in Australia was the taxing of all gains accruing after the introduction of the legislation and Evans labels this as one of the most significant problem areas.⁹⁴ The initial proposal in the Draft White Paper was for the Australian regime to tax all gains with a valuation method used for assets acquired prior to the introduction of the tax.⁹⁵ Prior models, such as the United Kingdom regime introduced in 1965, offered taxpayers a choice between fair market value or apportionment as methods for determining the taxation of capital gains realised after the introduction of

⁸⁵ Ibid, citing the Second Reading Speech to the Tax Law Improvement Bill (No 1) 1998 on 13 May 1998.

⁸⁶ Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?', above n 6.

⁸⁷ For a comprehensive analysis of the legislative provisions see: Evans, 'CGT – Mature Adult or Unruly Adolescent?', above n 31.

⁸⁸ Review of Business Taxation (Australia) (John Ralph, chair), *A Tax System Redesigned: More Certain, Equitable and Durable, Final Report of the Review of Business Taxation* (Australian Government, July 1999) (Ralph Review), available at: <https://rbt.treasury.gov.au/>.

⁸⁹ Henry Review, above n 3.

⁹⁰ For a commentary on Australia's earlier tax reviews see: Chris Evans and Richard Krever, 'Tax Reviews in Australia: Before and After Henry' [2009] 4 *British Tax Review* 339.

⁹¹ Cooper and Evans, above n 1.

⁹² Most recently, there have been changes to the taxation of Australian assets held by non-residents. However, this is a topic worthy of consideration as an investigation in its own right and, as such, is outside the scope of this article.

⁹³ Evans, 'CGT – Mature Adult or Unruly Adolescent?', above n 31, 305.

⁹⁴ Ibid.

⁹⁵ Ibid.

the legislation on assets acquired before that date⁹⁶ and was suggested as a possibility within the Australian model. However, ultimately, and after opposition in the Senate (upper House of Parliament), 'the compromise of "grandfathering", a uniquely Australian outcome that has bedevilled the Australian CGT since inception'⁹⁷ was reached. This is a position that Krever notes is 'condemned by tax economists throughout the nation and is often raised in international forums as an example of an absurd anomaly that should not be followed again'.⁹⁸

In 2004, Evans proposed the phasing out of the grandfathered status of pre-1985 assets arguing that it is unique, anomalous, complex, inefficient and inequitable.⁹⁹ In 2010, the Henry Review recommended that 'grandfathering' be removed and New Zealand may wish to take note of this recommendation. It stated:¹⁰⁰

Recommendation 17:

The capital gains tax regime should be simplified by:

- (c) removing current grandfathering provisions relating to assets acquired before the commencement of capital gains tax, with a market value cost base provided for those assets when the exemption is removed, or before the end of previous indexation arrangements. A relatively long lead-time should be provided before these removals take effect; ...

Associated with timing and recognition issues is the question around taxing gains on an accrual or realisation basis. Under an 'ideal' model based on the comprehensive tax base, capital gains would be taxed on an accrual basis. Taxing capital gains on a realisation basis provides a deferral advantage as it lowers the effective tax rate on accrued capital.¹⁰¹ This potentially impedes the 'efficient functioning of the capital market and distorts ownership patterns as investors are discouraged from switching assets when they would pay tax on a realised gain'.¹⁰² However, this is generally considered unrealistic as there are practical impediments to such an approach. First, there is the need to accurately measure changes in asset values where there has been no actual realisation. Second, adopting such an approach would also add to compliance costs and differential tax treatments of assets. Third, taxing according to an accruals basis also has liquidity issues for taxpayers whose value is tied up in the asset rather than accessible for the purposes of paying any tax due. Fourth, taxing inflationary gains erodes consumption power and, in this context the alternative is seen as a better option as 'the impact of inflation is less of an issue for capital gain assets where taxation is deferred until realisation. In this case, the real post-tax return increases the longer an asset is held'.¹⁰³ Because of these pragmatic concerns, the realisation basis of taxing capital gains is generally adopted. However, this also is not without its issues.

⁹⁶ Canada also adopts a similar approach.

⁹⁷ Cooper and Evans, above n 1.

⁹⁸ Richard Krever, 'The Taxation of Capital Gains' in Stan Ross and Philip Burgess (eds), *Income Tax: A Critical Analysis* (Law Book Company, 2nd ed, 1996) 67, 107-108.

⁹⁹ Chris Evans, 'Taxing Personal Capital Gains in Australia: Complexity and Proposals for Reform' (2004) 19(3) *Australian Tax Forum* 371, 408.

¹⁰⁰ Henry Review, above n 3, Pt 1, 84.

¹⁰¹ Henry Review, above n 3, Pt 2, Vol 1, 63.

¹⁰² *Ibid.*

¹⁰³ *Ibid* Pt 2, Vol 1, 65.

The most significant problem associated with the realisation model is what is known as the 'lock-in' effect. Essentially, taxpayers defer disposing of assets to defer the payment of any tax on the realised gains. This is exacerbated in Australia because of the grandfathering of certain CGT assets.¹⁰⁴ In addition, taxation based on the realisation principle also provides tax arbitrage opportunities as a taxpayer has an incentive to hold assets which have made a gain and realise assets which have made a loss. The consequence of this arbitrage opportunity is that a CGT regime generally needs a provision restricting the use of losses. It is also argued that under the realisation principle, additional complexity and compliance costs are introduced. The Henry Review states:¹⁰⁵

Under a realisation-based tax, taxpayers are required to keep records for long periods, and are also likely to have less frequent exposure to the relevant tax rules. Separating capital gains from other forms of income also creates uncertainty, and arbitrage opportunities, over how particular forms of income should be classified for tax purposes.

There is considerable discussion in the literature concerning lock-in, and the accruals versus realisation basis.¹⁰⁶ It is generally accepted that lock-in is produced by not taxing capital gains on an accruals basis. However, this does not necessarily mean that lock-in is produced by taxing capital gains on a realisation basis in itself. Rather, not taxing capital gains at all may produce more lock-in than taxing them on a realisation basis. Furthermore, Taylor discusses a number of provisions that arise due to the grandfathering of pre-CGT assets and other exemptions, such as the private residence, suggesting a number of possible reforms.¹⁰⁷

4.3 Indexation versus discount

When Australia first introduced a CGT, the model contained a provision allowing the cost of an asset to be indexed to take into account inflation in determining the net capital gain to be taxed. This approach, which ensured only real gains rather than notional or inflationary gains were taxed, remained in the regime from 1985 to 1999 when it was replaced with a discount method. The rationale for indexation, which was tied to inflation, was to ensure that only 'real' gains were taxed. The change to the discount method, introduced in 1999 as part of the Ralph Review recommendations, was 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'.¹⁰⁸ It was recognised by the Ralph Review that 'an exclusion of 50 per cent of capital gains for eligible assets held for a year or more by individuals will increase

¹⁰⁴ Evans, 'CGT – Mature Adult or Unruly Adolescent?', above n 31, 307.

¹⁰⁵ Henry Review, above n 3, Pt 2, Vol 1, 64.

¹⁰⁶ See, for example, Matthew Benge, 'Capital Gains and Reform of the Tax Base' in John G Head and Richard Krever (eds), *Taxation Towards 2000* (Australian Tax Research Foundation, 1997) 351 and Charles C Holt and John P Shelton, 'The Lock-in Effect of the Capital Gains Tax' (1962) 15(4) *National Tax Journal* 337; Alan J Auerbach, 'Retrospective Capital Gains Taxation' (1991) 81(1) *American Economic Review* 167.

¹⁰⁷ C John Taylor, 'CGT Reform and the Reduction of Tax Law Complexity' (2008) 23(4) *Australian Tax Forum* 427. The provisions noted in this article are also noted in some of the simplification literature; see for example, Chris Evans and Binh Tran-Nam, 'Controlling Tax Complexity: Rhetoric or Reality?' in Chris Evans, Richard Krever and Peter Mellor (eds), *Australia's Future Tax System: The Prospects After Henry* (Thomson Reuters, 2010) 439.

¹⁰⁸ Ralph Review, above n 88, 598.

significantly the attractiveness of investing in capital-gains-bearing assets by individuals'.¹⁰⁹ As Evans explains, the focus of the CGT reforms recommended by the Ralph Review centred on optimising economic growth, with very little focus on equity and only some recognition of the importance of simplicity and certainty.¹¹⁰ The discount method currently adopted by Australia is in line with the Canadian model, while other jurisdictions such as Portugal, Chile and Spain maintain a methodology that takes into account inflation. However, most OECD countries treat the full capital gain as taxable, with some providing for an exemption up to a fixed amount.¹¹¹

The abolition of indexation and replacement with the 50 per cent discount method largely reintroduced inequity into the system by preferentially taxing gains. As Evans notes, the essential reason for introducing a CGT is one of equity, yet a 50 per cent discount 'savagely offends both the horizontal and the vertical aspects of equity'.¹¹² It has already been noted that salary earners are disadvantaged over investors and that wealthier individuals tend to be the ones who invest for capital gain. This inequity can also be demonstrated by comparing the taxing of capital gains with the taxing of other forms of savings income and, in this context, it is necessary to consider how the taxation of capital gains fits within the broader tax system and the taxation of savings income. For example, in Australia, interest is taxed the least favourably because the entire return, including any inflationary gain, is taxed at marginal rates. On the other hand, dividends and investment in shares is taxed favourably, with dividends attracting a dividend imputation credit and capital gains from the sale attracting the CGT discount. Property is also taxed favourably depending on whether there are gains or losses, with the CGT discount again applying to any gain, and owner-occupied housing is exempt altogether from tax. That said, capital gains on shares are arguably preferred relative to interest because of the CGT discount. Furthermore, with a fully effective imputation system (this includes where excess imputation credits are refundable) dividends are taxed at the shareholder's average tax rate and this treatment applies to the taxation of interest as well.

Different tax consequences between capital gains, interest, dividends and real property, as illustrated above, result in obvious horizontal inequity in the tax regime. As noted by the Henry Review, these differences affect the assets in which households invest, leading to 'adverse impacts on overall economic efficiency, capital market stability and the distribution of risk between individuals'.¹¹³ Because of the tax incentives, investors tend to take on too much debt, and in the case of real estate, it leads to a distortion in the property market.¹¹⁴ Further compounding this favourable treatment of capital gains under the personal income tax system is the fact that investments can be geared so as to bring about interest deductions against the gains from the investment. To this end, the Henry Review recommended major reform in this area. It stated:¹¹⁵

¹⁰⁹ Ibid 599.

¹¹⁰ Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?', above n 6.

¹¹¹ OECD, *Taxation of Dividend, Interest, and Capital Gain Income*, OECD Tax Working Papers No 19 (OECD, 2013) 35.

¹¹² Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?', above n 6.

¹¹³ Henry Review, above n 3, Pt 1, 33.

¹¹⁴ Ibid.

¹¹⁵ Henry Review, above n 3, Pt 1, 83.

Recommendation 14:

Provide a 40 per cent savings income discount to individuals for non-business related:

- (a) net interest income;
- (b) net residential rental income (including related interest expenses);
- (c) capital gains (and losses); and
- (d) interest expenses related to listed shares held by individuals as non-business investments.

It will be noted that, not only did the Henry Review recommend that the discount be reduced to 40 per cent, but also that it be extended to 'like' types of income. The rationale for this recommendation was that by discounting net rental income at the same rate as capital gains, the tax treatment of investor housing would be less responsive to gearing levels and capital gains, creating a more neutral treatment of different forms of savings. They argued that the 'proposed reforms would reduce the bias in favour of the capital gain generated in rental properties by treating it more neutrally compared to rental yield'.¹¹⁶ However, in 2010, the then Federal Government ruled out any reduction in the discount rate.

In terms of the inequity of the current system, the Henry Review stated that:

a move to a broad 40 per cent discount for income from bank deposits, bonds, rental properties, and capital gains and for certain interest expenses would address these problems by providing more consistent tax outcomes. Savings would be allocated more productively, distortions to rental property and other markets would be reduced, and household investment and financing choices would better suit their circumstances and risk-preferences. The discount would also provide a means of adjusting for the effect of inflation, which increases the effective rate of tax on savings income.¹¹⁷

A reduction in the discount rate, along with its extension to other forms of income, does not necessarily reduce the inequity between the taxing of capital and labour income. To this extent, the Henry Review also recognised the need to consider how the boundaries are set between discounted and non-discounted amounts:

to achieve certainty, reduce compliance costs, and prevent labour and other income being converted into discounted income. Further consideration should also be given to addressing existing tax law boundaries related to the treatment of individuals owning shares in order to address uncertainties about when the shares are held on capital account (and subject to CGT) and on revenue account (and taxed as ordinary income).¹¹⁸

Australia's adoption of an indexation method to calculate any net capital gain, followed by its replacement with a 50 per cent discount, offers two examples of how CGT models

¹¹⁶ Ibid Pt 2, Vol 2, 417-418.

¹¹⁷ Ibid Pt 1, 33-34.

¹¹⁸ Ibid Pt 1, 83.

can be implemented. However, we suggest that the 50 per cent discount is suboptimal due to the inequity which is inherent in such a regime.

4.4 Exemptions and concessions

Perhaps one of the most controversial aspects of the CGT regime in Australia involves the exemptions and concessions, of which there are many. Australia's current CGT regime applies to all CGT assets unless either the asset is exempt or the capital gain or loss is exempt. Of significance are the following:

1. Exemption for main residence;
2. A gain made from personal use assets, acquired for less than \$10,000 and all losses from personal use assets;
3. Collectables acquired for up to \$500;
4. Motor vehicles;
5. Trading stock; and
6. Depreciable assets.

The housing market is perhaps one of the most affected markets when it comes to tax policy. In section 4.3 above, we discussed the influence the CGT discount can have on housing policy. In addition, it has been noted that '[t]he housing market is also affected by the exemption of owner-occupied housing from the personal income tax and the capital gains tax system...'.¹¹⁹ There is an incentive to invest in a main residence for capital growth which is then tax free on realisation. However, taxing capital gains on main residences is one of the most politically contentious issues around CGT. No doubt, this would also be controversial in New Zealand if a CGT was introduced. In Australia, the consequence of the main residence exemption has been individuals over investing in their homes on the basis that any capital gain is free from tax. Further, there is no limit on the amount which can be spent on the gain that can be exempt on a main residence provided the property meets the necessary requirements, and the land size for the exemption is extremely generous and beyond the size of most urban properties. To date, Australia has not had a backlash against the taxation of vacation properties. However, this may occur in New Zealand as the ownership of vacation properties seems to be more common in New Zealand than Australia.¹²⁰

Small business CGT concessions are also controversial and can be particularly advantageous to those who can access them. Taxpayers who can access these

¹¹⁹ Ibid Pt 2, Vol 2, 415.

¹²⁰ On the transition in the Australian vacation property sector to one involving both dwelling and investment ownership, see Chris Paris, 'The Changing Ecology of Australian Second Homes' (2017) 14(3.4) *e-Review of Tourism Research* 92; and on the broader evolution of the New Zealand second home sector over many decades and the government policies of the different eras, see Trudie Walters, 'Caves to Castles: The Development of Second Home Practices in New Zealand' (2019) 11(1) *Journal of Policy Research in Tourism, Leisure and Events* 1.

concessions certainly welcome these concessions.¹²¹ A small business is able to access the concessions where it has an annual turnover of less than AUD 2 million or net assets do not exceed AUD 6 million. Where a small business meets one of the threshold tests, it may access one or a combination of the 15-year asset exemption, 50 per cent active asset reduction, retirement exemption or a roll-over. The 15-year asset exemption will exempt the total capital gain from tax where the taxpayer is 55 years or older and retiring, and has owned an active asset business for at least 15 years. The 50 per cent active asset reduction means that where a taxpayer owned an active business asset (asset used in the business) tax will only be paid on 50 per cent of the gain. The retirement exemption allows a taxpayer who is under 55 to contribute up to AUD 500,000 tax free to a complying superannuation fund and a taxpayer who is over 55 to have an exemption for the AUD 500,000. Finally, a roll-over allows the taxpayer to defer any tax on the capital gain to purchase a replacement asset. These small business concessions may also be applied in conjunction with the 50 per cent discount.

The rationale for favourable treatment is that for many business owners, their personal effort and capital investment is rewarded through appreciation of the value of the business and its assets, often in the form of goodwill and intangible assets. For self-employed taxpayers, the concessions mean that tax on business gains can be deferred until ultimately realised and that gain on realisation is significantly reduced, if not completely exempted. There are obvious efficiency and equity concerns around these concessions and the effect that they have on the labour market favouring self-employment.¹²²

The question remains as to why a country would adopt small business concessions. Apart from the political perspective that these concessions make a CGT more palatable, there can be alternative rationales for them. This includes roll-over of such incentives from one business to another, as well as providing incentives for start-ups. With respect to start-ups, the Australian concessions largely apply at what is the wrong end for most small businesses. That is, these concessions are provided largely when the business ends rather than when it commences.¹²³

These small business concessions are a known area of significant complexity within the CGT regime. Evans has previously found that these concessions ranked prominently in the drivers of CGT compliance costs.¹²⁴ He concluded that not only have these provisions become more complex over time but that the provisions are so complex that professional advice is normally required before a taxpayer can avail themselves of the benefits of the provisions.

Further, simplicity may be introduced into a CGT regime via an indexed annual exempt amount as proposed by Evans in 2004.¹²⁵ Data shows that a large percentage of individuals contribute a very small proportion of the tax on capital gains. As such, an annual exempt amount would significantly reduce compliance costs for many taxpayers. This proposal was further investigated by Evans, Minas and Lim in their 2015 study.

¹²¹ Evans, 'CGT – Mature Adult or Unruly Adolescent?', above n 31, 313.

¹²² Henry Review, above n 3, Pt 2, Vol 1, 51.

¹²³ See for example, Naomi Kewley, 'The Old, the New, and the Ugly: A Comparative Analysis of the UK, South African and Australian CGT Small Business Concessions - With Recommendations for Australia' (2013) 28(2) *Australian Tax Forum* 257.

¹²⁴ Evans, 'Taxing Personal Capital Gains in Australia: Complexity and Proposals for Reform', above n 99.

¹²⁵ *Ibid* 411-412.

As the authors point out, preferential CGT rates are 'usually linked to providing an incentive for entrepreneurship and risk taking, increasing the level of saving, investment and productivity and counteracting the "lock-in effect"'.¹²⁶

Again, as noted in section 4.2 above in relation to the grandfathering rule, the most recent review of Australia's tax system which New Zealand may wish to take note of is the suggested simplification of the current regime around exemptions and concessions:

Recommendation 17:

The capital gains tax regime should be simplified by:

- (a) increasing the exemption threshold for collectables and exempting all personal use assets;
- (b) rationalising and streamlining the current small business capital gains tax concessions by:
 - removing the active asset 50 per cent reduction and 15-year exemption concessions;
 - increasing the lifetime limit of the retirement exemption by permanently aligning it with the capital gains tax cap for contributions to a superannuation fund; and
 - allowing taxpayers who sell a share in a company or an interest in a trust to access the concessions via the turnover test.

5. RECOMMENDATIONS FOR NEW ZEALAND

In conclusion, in this section we outline both considerations and recommendations which will be relevant, should New Zealand seriously consider a CGT in the near future. While policy considerations in section 2 of this article may provide an 'ideal' regime, it can be seen from the pragmatic considerations in section 4, that there are many variations to such a model. Indeed, earlier in section 3, which reviewed the CGT debate in New Zealand, it could be argued that the country is ideally positioned to embrace a formal CGT proposal.

The recommendations made in Australia's most recent comprehensive tax review, combined with previous studies, suggest that Australia's exemptions and concessions provide too much complexity within Australia's CGT regime and this is compounded when combined with grandfathering of pre-1985 assets. Broadly, the Henry Review found that 'the current capital gains tax rules are particularly complex, with that complexity compounded by various exemptions and the grandfathering of previous provisions',¹²⁷ and provided recommendations around simplifying the regime to address these issues. Perhaps then the most significant lesson from Australia for New Zealand is centred on the complexity found in the current model. While the system itself may be considered complex by necessity, this is compounded by both the grandfathering of pre-CGT assets along with the various exemptions and concessions. The most complex

¹²⁶ Evans, Minas and Lim, 'Taxing Personal Capital Gains in Australia: An Alternative Way Forward', above n 14, 745-746.

¹²⁷ Henry Review, above n 3, Pt 2, Vol 1, 80.

areas are discussed above, and perhaps one of the most complex is the various concessions for small business.

This complexity has been recognised in prior studies. Evans, in a 2004 study involving surveys of over 300 practitioners, found that:¹²⁸

1. CGT compliance costs are significant;
2. they derive primarily from the complexity of the legislative provisions;
3. legislative changes in the late 1990s did little to improve the position; and
4. the CGT provisions are a major concern for practitioners.

Several of the above features of Australia's CGT regime, such as grandfathering, and the exemptions and concessions, contribute to this complexity. As noted earlier, simplicity may be introduced into a CGT regime via an indexed annual exempt amount.¹²⁹

In order to advance a CGT for New Zealand, there needs to be a champion for the tax, which by necessity needs to be a senior member of the government. There would also need to be an educational programme to accompany the CGT policy proposal, as well as when the legislation is enacted (but prior to it coming into effect). In developing the New Zealand CGT model, we would argue that the lessons of the Australian experience are pertinent to developing a New Zealand -specific CGT. Thus, grandfathering of pre-CGT assets would not be sensible, and the number of exemptions and concessions should be minimal. The CGT should apply on a realisation basis, rather than accrual basis. It would need to exempt the family home in order to be politically palatable.¹³⁰ Building upon New Zealand's experience with introducing its goods and services tax over the period of 1984-1986, this would suggest that New Zealand should develop a largely 'pure' CGT and deal with major equity concerns outside of the CGT through other mechanisms, such as via income support.

Any possible CGT would ideally embrace simplicity and efficiency to ensure it would best fit within the current Broad Base Low Rate (BBLR) framework that operates in New Zealand. The BBLR is a coherent tax policy framework that seeks to appropriately balance (with trade-offs) a number of factors: efficiency; fairness; compliance costs; and administration costs. It aims to have a broad base of taxation while keeping tax rates as low as possible. Currently, the most significant 'gap' in New Zealand's BBLR is the absence of a CGT.¹³¹ In order to buttress its BBLR, New Zealand should be actively pursuing the introduction of an appropriately structured CGT. For this to occur, it may

¹²⁸ Evans, 'Taxing Personal Capital Gains in Australia: Complexity and Proposals for Reform', above n 99, 401.

¹²⁹ Evans, Minas and Lim, 'Taxing Personal Capital Gains in Australia: An Alternative Way Forward', above n 14, 745-746.

¹³⁰ See the comments by Michael Littlewood, 'Capital Gains Taxes – A Comparative Survey' in Michael Littlewood and Craig Elliffe (eds), *Capital Gains Taxation: A Comparative Analysis of Key Issues* (Edward Elgar, 2017) 1, 28.

¹³¹ For further discussion on the BBLR, see Adrian Sawyer, 'Do Lawyers Make a Distinctive Contribution to Tax Policymaking?: Reflections on the Contributions of Lawyers to Tax Policymaking in New Zealand' (2017) 27(4A) *New Zealand Universities Law Review* 995.

require a change in government or serious financial crisis that puts the New Zealand tax base at significant risk.

With New Zealand operating its 'Generic Tax Policy Process' (GTPP), there is the opportunity for considerable input from stakeholders into both the policy composition and the draft legislation. The GTPP clarifies the responsibilities and accountabilities of the two major departments actively involved in the process (namely Inland Revenue and The Treasury). It also encourages earlier and more explicit consideration of key tax policy elements and trade-offs through the linking of its first three stages. Finally, the GTPP provides an opportunity for external input (such as from legal practitioners and firms) into the process for formulating tax policy. Such an approach seeks to facilitate both the actual and perceived transparency of the process, and provide for greater contestability and quality of policy advice.¹³² New Zealand's experience with the GTPP has largely been successful with previous major tax changes since the process commenced in 1994. There is no reason to believe this should not be the same with introducing a well-constructed CGT.

The OECD, in a 2000 Economic Survey of New Zealand, recommended the introduction of a separate CGT.¹³³

Seventeen years later, we are yet to see a change to this view or the adoption by the New Zealand government of the OECD recommendation. However, as Evans comments: '[t]he Australian CGT has endured bucket loads of amendments and refinements since 1985, and it is certain that there will be many more in the future. By its very nature the CGT will never be a simple tax'.¹³⁴ In this context, New Zealand can benefit from the Australian experience that is more than 30 years in the making.

¹³² See further Adrian Sawyer, 'Reviewing Tax Policy Development in New Zealand: Lessons From a Delicate Balancing of "Law and Politics"' (2013) 28(2) *Australian Tax Forum* 401.

¹³³ OECD, *OECD Economic Surveys: New Zealand* (OECD, 2000).

¹³⁴ Evans, 'CGT – Mature Adult or Unruly Adolescent?', above n 31, 321.