# THE CASE FOR CAPITAL GAINS TAX REFORM

## A FAIRER TAX SYSTEM AND HOUSING MARKET FOR ALL

Reforming Capital Gains Tax would be one of the most effective ways to remove the massive structural inequity in our tax system and housing market. The Australian Greens have released PBO costings that show that phasing out the Capital Gains Tax (CGT) discount and Negative Gearing could generate $7 billion over forward estimates and over $119 billion over the next ten years.

## > QUICK FACTS

- The CGT discount is Australia's 6th largest tax expenditure and will cost $6.8 billion in the 2016-17 financial year
- The discount goes mostly to the very wealthy, with over 73% of the benefit flowing to the top 10% of income earners
- There's no reason why wealthy Australians who generate income from investments such as property should be taxed at a different rate than everyone else
- The Grattan Institute and Reserve Bank are among many groups pushing for a review of the discount, saying the Australian community should expect to get something significant in exchange for that kind of benefit
- In June 2015, the PBO estimated the Greens proposal to remove negative gearing with grandfathering of existing arrangements would raise $2.9 billion over forward estimates, and $42 billion over the next ten years

## > WHAT IS THE CGT DISCOUNT?

Broadly speaking, Capital Gains Tax (CGT) is paid when an asset is sold for more than it was purchased for, minus some deductions. Since 1999, Australia has a 50 per cent discount on CGT if the asset was held for more than 12 months by individuals or trusts. The discount means that only half the capital gain made on an investment is subject to tax.

For example, if an investment property was purchased for $200,000 and later sold for $500,000 - the investor made a capital gain of $300,000 – but only 50 per cent (or half) of that amount is actually taxed. The tax applies to capital gains realised when an asset is sold[i] and owner-occupied housing is exempt.

## > WHAT DOES IT COST?

According to the most recent figures from Treasury's *Tax Expenditure Statement,* the capital gains discount will cost $6.84 billion in 2016-17, and $7.6 billion in 2017-18 in lost revenue. The discount is Australia's sixth largest tax expenditure.[ii]

Property investment makes up the highest proportion of assets attracting the capital gains discount (40%) followed by shares (37%) and other assets (20%) including collectibles[iii].

## > THE GREENS PROPOSAL

In March 2016 the independent Parliamentary Budget Office (PBO) provided the Greens with costings that estimate the *combined effect* of progressively phasing out the Capital Gains Tax Discount over five years, in addition to the Greens existing proposal to phase out Negative Gearing.

Specifically, the PBO costing estimates the proposal to phase out the Capital Gains Tax (CGT) discount for individuals and trusts, applied to all assets sold on or after 1 July 2015, at a rate of 10 per cent each year for five years to phase out entirely by 1 July 2020. This costing was accompanied by the Greens proposal to remove negative gearing for all non-business assets after 1 July 2016, with existing arrangements grandfathered.

**It estimated this proposal would raise $7.028 billion over forward estimates (2016-2020);**


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**and $119.5 billion over the next ten years.**

## > WHO CURRENTLY BENEFITS?

The data shows the vast majority of benefits go to the wealthy. NATSEM data shows 73% of capital gains discounts go to the top 10% of households by income levels (Figure 1)[iv].

The most recent ATO data also shows 506,070 individuals reported a net capital gain in the 2012-13 income year - of these 70% had a taxable income over $180,000, and only nine per cent had taxable incomes less than $80,000.[v]

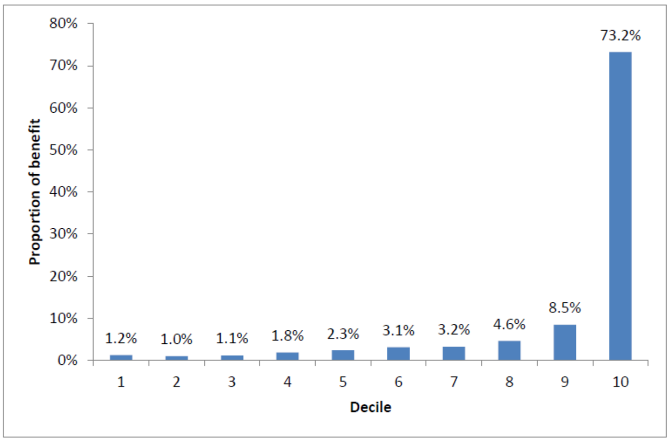



*Figure 1: Distribution of the CGT discount by household income (Source: NATSEM, ATO [2014] Taxation Statistics 2011-12, updated to 2014-15 in The Australia Institute 2015)*

## > INTERACTION WITH NEGATIVE GEARING

One of the major problems in our housing market is the way the current capital gains discount encourages negative gearing and speculation in the property market, which drives up housing costs and locks out first home buyers, as well as creating a rental market that is stacked in favour of investors rather than tenants.

Normally investors would not be interested in an investment that is expected to run at a loss. But many are happy to purchase property where the rental income doesn't cover the interest payments because they expect to make large capital gains in the future from selling it – which are taxed at a massive discount.

When the headline rate of capital gains tax was cut to half the income tax rate by then Prime Minister John Howard in 1999 it made negative gearing much more attractive - and also sparked a climb in house prices[vi]. Figures clearly show as soon as the capital gains discount was introduced, Australia suddenly became a 'nation of losers'; in the financial year before the discount was introduced property investors actually reported a net rental income of $219 million, but in 2000-2001 suddenly investors reported almost half a billion dollars in *losses*, with the amount rising radically over the next ten years to $7.9 billion in 2011-12 (Figure 3).

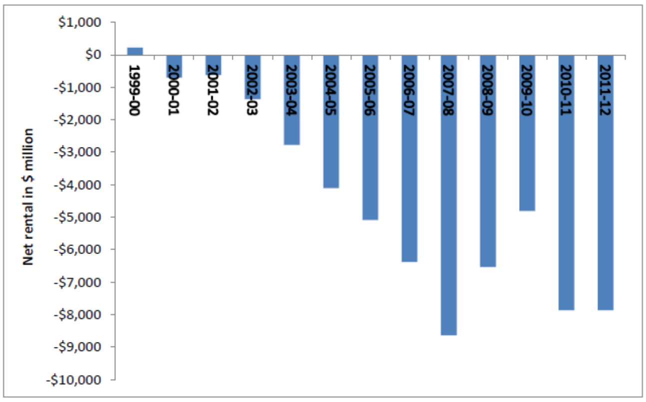



*Figure 3: Net rental loss (negative gearing) over time since the introduction of the CGT discount. Source: ATO (2014) Taxation Statistics 2011-12, Individual tables, Table 13.*

Not only does capital gains tax discount encourage property investors to speculate on massive windfall gains that they are not taxed fairly on, but the benefits of the combined negative gearing and capital gains discount, worth about $7.7 billion per year, are skewed towards higher income earners:

- 56 per cent of the benefit going to the top 10 per cent of income households
- Just four per cent of the benefit goes to the bottom 20 per cent of households

Data also shows the dollar value of the combined benefit is also worth much more to higher income earners:

- The weekly dollar value of the benefit of the discount is worth $1.00 to the lowest income quintile but $6 per week to the middle quintile and $30 per week to the highest quintile (Figure 3).

- The top 20% receive thirty times the amount of the benefit received by the lowest bracket, and five times the benefit than middle income earners receive.

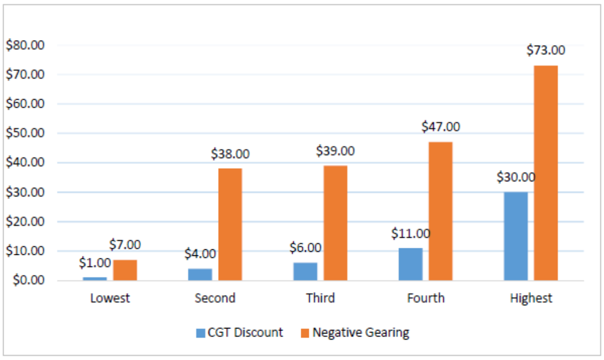


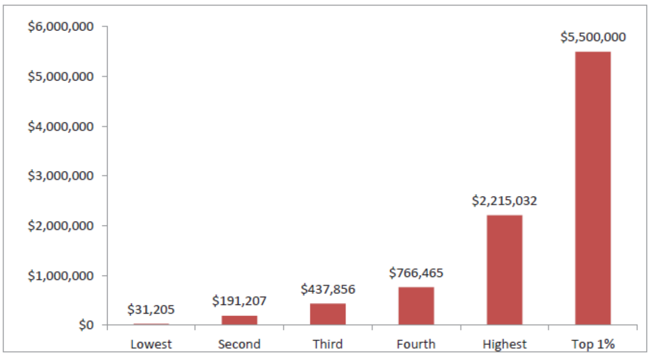

*Figure 4: Which households benefit from the capital gains tax discount and negative gearing? Source: ACOSS 2015 using Yates (2010) data*

# > CAN THE DISCOUNT BE JUSTIFIED?

The discount is also almost impossible to justify. A core principle of any modern tax system is that is fair, progressive, and has integrity in the way it rewards work and savings. The capital gains discount fails on all counts.

## Is it fair?

The discount goes to people who are generating income through *assets* (like property, shares and art for example) rather than income. This is all the more important given inequality in Australia is now driven by the distribution of assets not income. In fact asset inequality is at least 14 times worse than income inequality in Australia. The top 20 per cent have five times more income than the bottom 20 per cent - but hold 71 times more wealth (Figure 5)[vii].




Source: ABS (2013) *Household wealth and wealth distribution, Australia, 2011-12.*

*Figure 5: The distribution of wealth in Australia, showing the average value of assets held by household income quintiles. (Source: The Australia Institute, 2014)*

Given households with higher incomes are on average, invested more heavily in investment properties and shares[viii] than lower income households, they obtain the greatest benefit from the CGT discount. ABS data shows:

- Households in the lowest income quintile own on average of $4500 in investment property assets, compared with those in the highest income quintile who own $467,000.
- Households in the lowest income quintile own on average $400 in shares, compared with $75,400 for those in the highest quintile[ix].

A tax system that is designed to provide significant discounts to the most wealthy and reinforces asset and income inequality is fundamentally unfair.

## Is it progressive?

The concession undermines the progressivity of the income tax system, that is, as people's income rises so does their ability to pay more tax. Instead, the discount provides a massive incentive for the wealthy to avoid paying higher marginal tax rates by structuring their tax affairs so that more of their income is in the form of capital gains[x].

This means the higher the marginal income tax rate the higher the benefit they receive from the concession. For example, a taxpayer on the top rate of 46.5 per cent benefits from a 23 per cent discount; but a taxpayer on the zero marginal rate (income under $18,000) gets no benefit at all[xi].

A tax system that is designed to enable the rich to access higher discounts and actively avoid tax paid on income, and where the majority of the lost revenue accrues to high income households is the opposite of progressive.

## Does it have integrity?

The capital gains tax concession discourages or discriminates against those earning income from savings and work – rather than accumulation of assets. No credible argument exists to justify why the creation of wealth through assets should be taxed at a different rate than the creation of wealth through income.

As Anglicare Australia says in its submission to the Taxation White Paper;

*'There are also issues of concern regarding the integrity of a system if it offers some of the more affluent members of our society a way of paying less tax. As detailed discussions of capital gains tax exemptions and negative gearing and superannuation point out, the tax system as it exists provides many tax minimising opportunities for those with greater resources, which are simply not available to the majority of taxpayers. If the tax system is to serve its broader purpose it needs to have integrity at its heart.'*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# > WHY WAS IT INTRODUCED?

Capital gains tax was introduced in 1985 by the Keating government as part of a tax base-broadening package. The discount was introduced by the Howard Government in 1999, following a report from the Ralph Review of Business Taxation, which recommended that only half of capital gains be taxed 'to encourage greater investment in venture capital' and 'support a stronger investment culture amongst Australian households[xii].' It certainly achieved its purpose - Australians have one of the highest rates of investment in OECD countries, particularly in property – but at a massive cost.

# > WHO SUPPORTS REFORM?

The Reserve Bank of Australia recently added its voice to the growing number calling for a review of negative gearing and the capital gains tax discount. Its submission to the government's inquiry into Home Ownership in June 2015 highlighted the way they work together to encourage leveraged investment in property and make capital gain-producing assets more attractive than income producing assets. The RBA concluded:

*"Given the value Australian and other households place on home ownership, policy should not unduly advantage property investors at the expense of prospective owner-occupier households. Financial stability considerations would suggest that tax and regulatory frameworks should avoid encouraging over-leveraging into property by investors.[xiii]"*

This is in addition to an overwhelming number of prominent economists and peak social bodies have made public statements and submissions to the government's Tax White Paper calling for its reform. Many groups pushing for a review of the discount are saying the Australian community should expect to get something significant in exchange for that kind of benefit, and that it's a much fairer place to generate revenue than raising the GST.

The Grattan Institute, GetUp!, Economists including Saul Eslake, and even Tony Shepherd, former Business Council president and chair of Tony Abbott's Commission of Audit support complete removal of the discount. Mr Shepherd recently said the 50 percent discount was "too generous" and he could see no reason for continuing it, saying:

*"I'm personally in favour of bringing the CGT rate up to the income tax rate… I can't see any reason to treat capital gains any different from income gains. I'm personally in favour of putting the rate up to the income tax rate, I can't see any reason for treating it differently, and I think it probably leads in some respects to a greater emphasis on negative gearing[xiv]"*.

Those against reform remain limited to those directly benefiting from the current arrangement, most notably property industry peak bodies including the Real Estate Institute of Australia and Property Council.

# > HOW WOULD PEOPLE BE AFFECTED BY REFORM?

Individuals currently benefiting from the capital gains tax discount are only paying *half* the rate of tax compared to what everyone else has to pay on their income and savings. Any reform to the capital gains discount will only mean these people pay a fairer share.

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[i] The theoretical ideal would be taxing capital gains as they accrue rather than just as they are realised, as deferring taxation favours capital gains over other forms of income and encourages 'lock in' of assets (a preference for holding on to existing assets). But the high administrative and compliance costs in valuing all the assets and the problems for those having to pay tax on gains not yet realised make this impractical.

[ii] Treasury, Tax Expenditures Statement 2014 *January 2015*

[iii] Capital gains tax: historical trends and forecasting frameworks. John Clarke, Tax Analysis Division, Australian Treasury. At http://treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2014/Economic%20Roundup%20Issue%202%202014/Documents/PDF/03Clark.ash

[iv] 'Top Gears' The Australia Institute April 2015

[v] ATO Taxation Statistics, 2012-13 Individuals, Table 3. Note the data on capital gains by asset type only includes those individuals who have submitted a capital gains tax schedule. In 2012-13, this was only 245,600 of the 506,070 individuals that reported a net capital gain.

[vi] PM's audit chief Tony Shepherd says it's time to more properly tax super, capital gains', June 22, 2015 Peter Martin The Age, at http://www.smh.com.au/federal-politics/political-news/pms-audit-chief-tony-shepherd-says-its-time-to-more-properly-tax-super-capital-gains-20150622-ghukru.html#ixzz3hpflwXq1

[vii] Richard Denniss and Charles Richardson, 2014, The Australia Institute.

[viii] ABS 2011-12 Household wealth and wealth distribution – Table 10 and 6

[ix] BS 2011-12 Household wealth and wealth distribution – Table 6 – Net worth quintiles, Household assets and liabilities

[x] '…income streams are being readily converted into capital gains streams'; Bernie Fraser, Trevor Boucher, John Freeland, Bob Gregory and Alison McClelland, *A Fair and Adequate Tax System*, May 1999, p 18.

[xi] The Australia Institute: Tax Equity, Reforming capital gains taxation in Australia, David Ingles, April 2009

[xii] 'Review of Business Taxation - A Tax system redesigned'. July 1999 at http://www.rbt.treasury.gov.au/publications/paper4/

[xiii] Reserve Bank of Australia (2015) Submission to the Inquiry into Home Ownership. House of Representatives Standing Committee on Economics. June 2015

[xiv] Mr Shepherd quoted speaking at a Committee for Economic Development of Australia conference in Canberra on Monday 22 June 2015, cited in 'CGT discount too generous: Tony Shepherd'. Australian Financial Review, Australia. Joanna Mather. 23 June 2015 [xiv] PM's audit chief Tony Shepherd says it's time to more properly tax super, capital gains. Peter Martin June 22, 2015.