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SAME AMOUNT, DIFFERENT TAX: CAPITAL INCOME TAX CALCULATOR

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The tax treatment of capital income has been in the news, with a general perception that individuals who earn capital gains pay much lower tax rates than wage and salary earners. Sometimes this is true. However, there are circumstances where the capital income of some households may be taxed at much higher rates than labour income – particularly for pensioners relying on interest income or young families saving for a home deposit, where the value of their savings are largely eroded by inflation.

In this note, we explain the complexity of capital taxation using examples from our new online tax calculator. We show three illustrative situations in which capital income can be either under- or over-taxed relative to labour income:

- **A high-return fixer-upper**: An individual who renovates a property and realises a large capital gain on sale.
- **Young couple relying on interest**: A couple saving for their first home deposit in a bank account – where the majority of their interest income simply offsets the negative effect of inflation on their savings.
- **Property investor in an inflation surge**: A case where high inflation causes nominal returns to overstate real gains.

Our online tool allows you to investigate how these different scenarios play out. It illustrates that while some forms of capital income are taxed more lightly than labour income (e.g. high-return capital gains), others are taxed more heavily in real terms (e.g. bank interest income). This tool can be found at https://e61.in/e61-capital-income-tax-calculator/.

Measuring tax rates

There has been considerable discussion about individuals paying very different effective tax rates – including Kaplan et al. (2025a), which examined how the taxation of capital gains shapes differences in tax paid between individuals with similar earnings. e61 is releasing a tax-tool that helps to explain why tax rates can look different for individuals with different incomes. This note illustrates how to use this tool and provides cameos of individuals who are savings may be either over- or under- taxed relative to a wage earner.

An effective tax rate is simply the amount of tax paid divided by income. Income reflects the resources someone has available to spend on consumption during a period of time, without reducing their stock of savings (net wealth). Under this definition, people with the same resources have the same ability to pay – and as a result it may be argued that they ought to pay a similar amount of tax. This is a key principle in the Australian tax system for two reasons: first, asking people with the same ability to pay to contribute in the same way feels fair; and second, taxing people similarly irrespective of how they receive their income does not distort choices and is thereby efficient.

Such a concept of income is measured as gross receipts minus the expenses required to generate that income – such as the cost of operating a work vehicle or the interest payments financing a business loan.

For wages, this is straightforward. Every dollar earned is a genuine, immediate addition to real wealth, whether spent now or saved. It is income. For capital income, things are more complicated – and this is where the current tax system runs into trouble.

When you earn capital income, part of that return is simply compensation for the fact that inflation is eroding the real value of your underlying wealth. For example, a capital gain equal to the inflation rate simply means that if you sold that asset now or in the future you could purchase the same number of goods and services at either time period. As a result, only a capital gain that is higher than inflation reflects real income – or the ability to buy more things.

Similar arguments can be made for capital income flows without a tradable capital value. On a term deposit, part of the interest rate you receive simply reflects the fact that the cash held in that deposit will decline in value due to inflation.

What this tells us is that there is an inflationary component of capital income that is not income at all – it is an expense associated with holding the asset. Like any other expense, it should be deducted from taxable income before a fair comparison with wages can be made.

Labour income is largely unaffected by the issue identified above.

Both labour and capital income *do* face higher taxes from inflation through bracket creep, where fixed tax thresholds don't adjust as nominal incomes rise, pushing people into higher brackets even when their real income hasn't changed. But bracket creep is a separate issue. It's about real income – both capital and labour – being taxed at a higher rate because tax thresholds haven't moved, *not* about inflation causing purely nominal gains to be taxed as if they were real income. The two shouldn't be conflated.

For the examples below, we assume that tax thresholds adjust for bracket creep and trace through how inflation changes the relative taxation of labour and capital income.

To illustrate how the relative taxation of capital and labour works in Australia, we have created a tax-transfer model which simulates the effective tax rate of an individual and compares their tax treatment if they were to earn income in one of three ways:

- **Labour income**: For example, salary or wage income from a job.
- **Non-gain capital income**: Flow income from a capital asset that will not be sold for a capital gain. The main example of this is interest earnings from a term deposit.
- **Asset income**: Income earned from an asset the individual sells for a realised capital gain. This includes both the non-gain and capital gain income from this asset over the holding period.

The non-gain income currently modelled here is treated for tax purposes in the same way as interest income. A number of other non-gain sources (e.g. superannuation fund earnings) are taxed under different rules and are not currently captured in the tool.

Scenarios

We pick three scenarios to illustrate how differently capital income can be taxed in the current system:

- **A high-return fixer-upper**: An individual who renovates a property and realises a large capital gain on sale.
- **Young couple relying on interest**: A couple saving for their first home deposit in a bank account where nominal returns are taxed but largely offset by inflation.
- **Property investor in an inflation surge**: A case where high inflation causes nominal returns to overstate real gains.

Scenario 1: The property doer upper

Alex, 47, earns $100,000 a year in wages. He decides to buy an investment property to do up himself and then on sell. He spends $500,000 in total – $300,000 purchasing the property and $200,000 (in purchase-date prices) on materials.

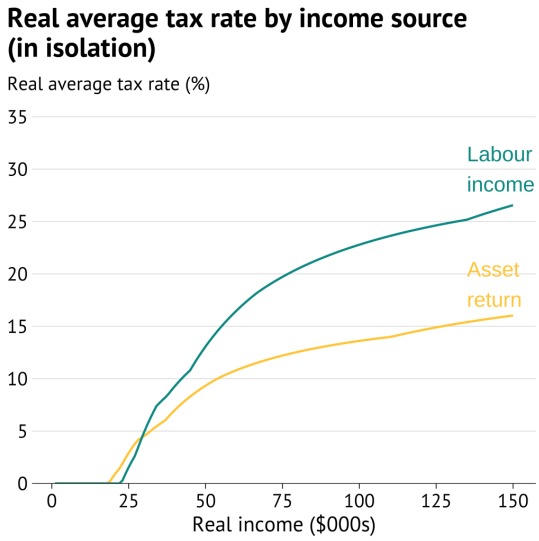
He sells the property two years later for $750,000, a nominal gain of $250,000 or an annual return of 22.5%. Under the 50% CGT discount, only $125,000 is included in his taxable income in the year of realisation.

Assuming inflation averaged 2.5% over these two years, the majority of this gain is real – the property has appreciated well above inflation.

Given this information, the before-tax real income from his job and developing the property are roughly the same. But the real tax rate on the capital gain is substantially lower – at 13.6% instead of the 22.8% tax rate on labour earnings.

This is both inequitable and inefficient. The tax system incentivises Alex to spend more time investing in and renovating property to on-sell, rather than working. Furthermore, it is inequitable, as a different individual who only earns labour income would have to pay a higher tax rate even with the same earnings potential as Alex.

Figure 1: Real Average Tax Rate of the 'Fixer Upper'



Source: e61 Institute

Scenario 2: Saving for the first house

Sarah and Tom, both in their early thirties, are saving for a first home deposit. Only Sarah is currently working, and earns $120,000 per year. They have squirrelled away $80,000 in a six-month term deposit earning 5 per cent annual interest rate. Compounding annually, this yields $4,000 per year in interest. At the same time, inflation is running at 3%.

At face value, these interest earnings are taxed the same way as labour income. As a result, if Sarah is able to work a bit more to earn $1,000, or instead earns this through interest (by saving an additional $20,000), both will face a nominal tax rate of 32%.

However, of that $4,000 received in interest, about $2,400 simply compensates them for the deposit losing real value over the year – in other words, 60% of the interest income would need to stay with the principal of the term deposit to maintain its value.

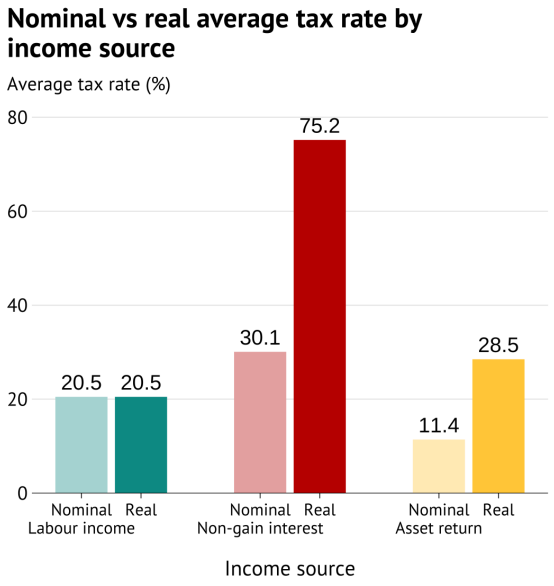
This implies that the *real return* is only $1,600, but income tax is levied on the full $4,000. As a result, the real tax rate on the income from their term deposit is 80% – as the government takes $1,280 in tax from this interest income at the end of the year.

Such high tax rates make it difficult to accumulate a deposit for a house. It is important to be clear that this does not mean Sarah is being lightly taxed on her labour income – the labour income tax rate shown assumes that Sarah is earning income to use now. The fact that she wants to save money to do something else, and that those savings are taxed at very high rates, implies that this labour income is effectively taxed more heavily once it is saved.

But this clarifies that the high tax rates faced by these young individuals trying to save for a house are driven by the punitive taxation of nominal interest income. This inequity is made even more egregious given the relatively favourable tax treatment of mortgage off-set accounts – meaning that individuals who have been able to get onto the property ladder can now earn higher post-tax income from their liquid savings.

These high tax rates are also punishing for individuals who rely on interest income – such as low- to middle-income retirees. Due to these high tax rates, older Australians are encouraged to instead find inflation-protected (and harder to access/less liquid) ways to support their retirement, such as investment in property. This can be shown in the example of earning $80,000 in real annual income under a 5% nominal return and 3% inflation in Figure 2.

Figure 2: High real tax on interest income



Source: e61 Institute

Scenario 3: The property investor facing high inflation

Priya, 36, bought an investment unit in early 2022 for $500,000. After three years of inflation averaging 6%, she sells for $600,000, a nominal gain of $100,000. The CGT discount reduces her taxable gain to $50,000. However, the inflation-adjusted cost base of the unit is approximately $596,000: her real gain is around $4,000.

Priya pays tax on $50,000 when her real gain is only $4,000. The inflationary component of the gain accounts for 96% of the nominal figure, yet the discount, designed to address inflation, only removes half.

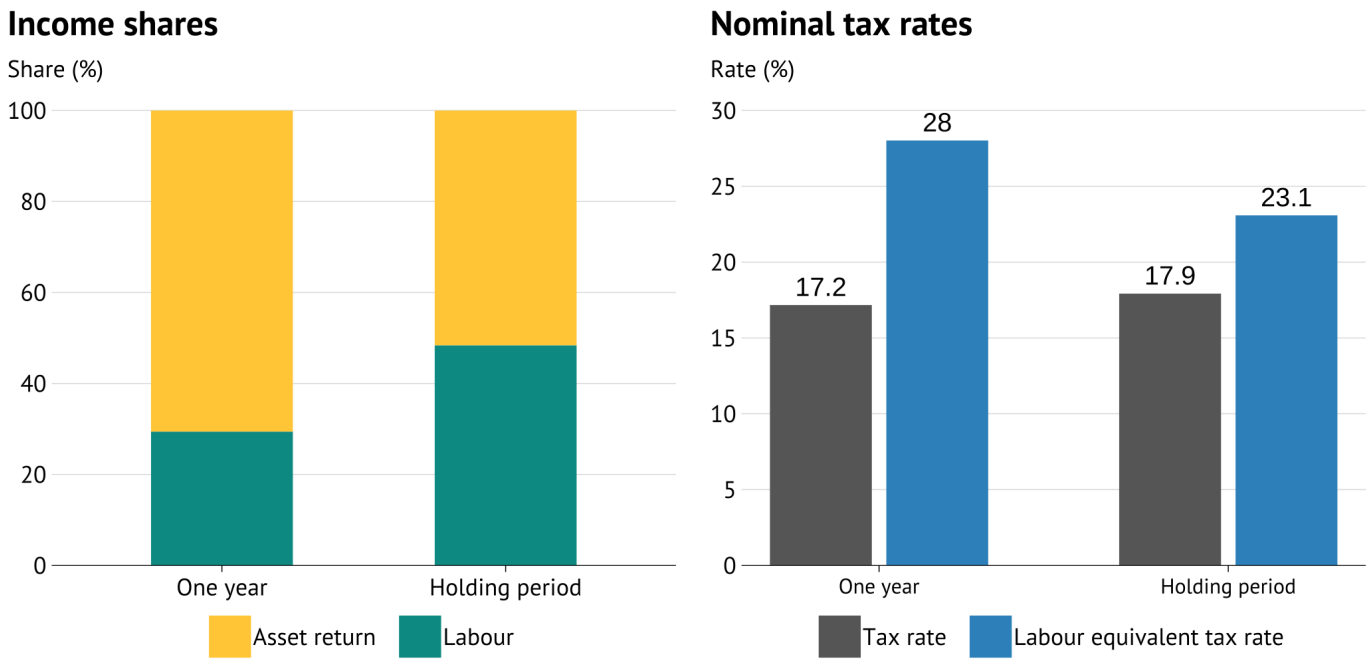
However, Priya was not just relying on capital gains. She also received $20,000 per annum in net rental income and $50,000 per year in a part-time graphic design job, both earned over the same three years.

Even in a high-inflation environment, her nominal tax rates look reasonable. In the year she sells, she pays an average tax rate of 17.2%. This is lower than the 28% tax rate she would have paid on an equivalent $103,000 of full-time work. But in this high-inflation environment, real capital returns were much lower. As a result, Figure 4 shows that the true real tax rate Priya pays is 39.2%.

If we consider the income she earns over the entire holding period of the asset, she faced an average real tax rate of 25.9% on her earnings. If she had earned an equivalent real income through wages alone she would have paid a lower tax rate of 19.1%.

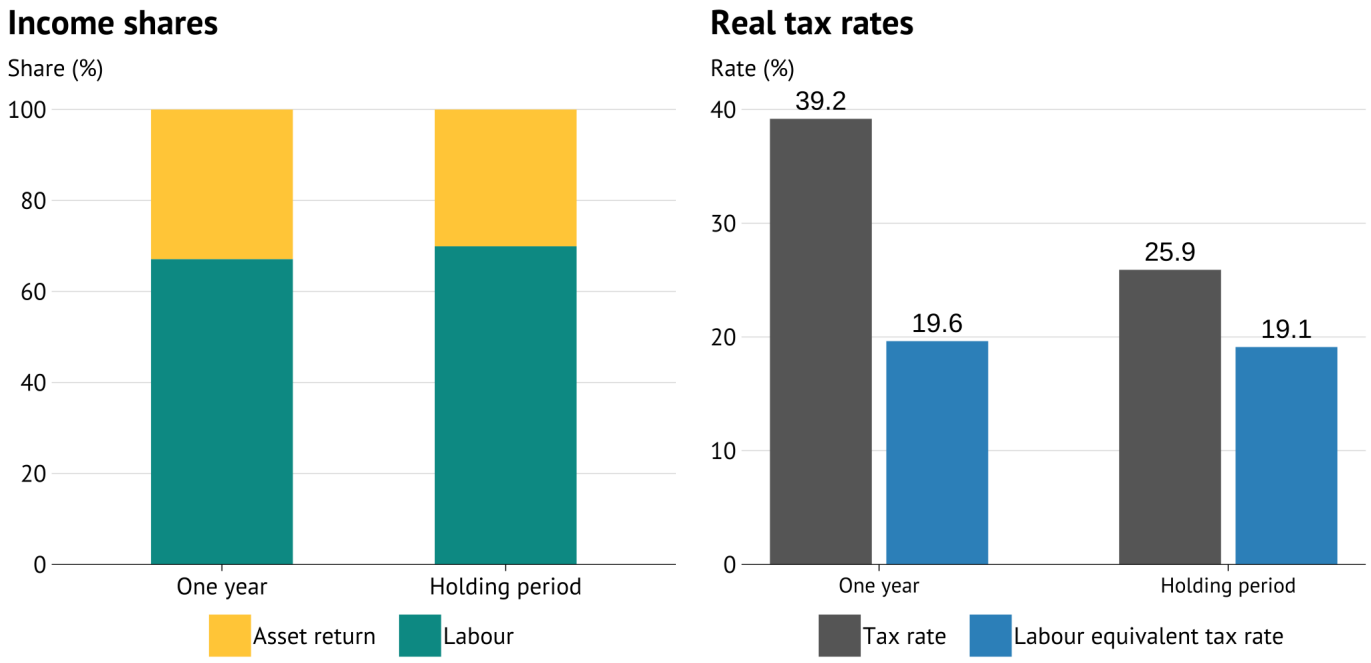
In this high inflation environment, even though Priya made a healthy 9.7% nominal return on her housing investment through rent received and capital gains she ended up facing a higher real tax rate than if she had instead transitioned into full time work. This is not a housing specific story, if she instead purchased shares and received regular dividends that provided similar cash flows inflation would have also eroded its value.

Figure 3: Nominal tax rates



Source: e61 Institute

Figure 4: Real tax rates



Source: e61 Institute

Key takeaways

The examples in this note highlight a simple but important point: the tax system does not consistently distinguish between nominal and real income.

When inflation is low, this leads to inequity from the design of the capital gains discount, and to concerns about the concessional treatment of such income.

But when inflation rises, it creates additional, large, and uneven distortions. Some forms of capital income – particularly high real-return capital gains – can be taxed at lower real rates than labour income. Others, such as interest income or inflation-driven capital gains, can be taxed at very high real rates.

These differences are not driven by differences in underlying economic income, but by how that income is measured for tax purposes.

A neutral system would instead tax real income consistently across sources. This means recognising that part of capital income simply reflects compensation for inflation, and excluding that component from the tax base as originally suggested in Diamond (1975). Doing so would not favour capital over labour, but would ensure that individuals with the same real income face similar tax rates regardless of how that income is earned.

Without this adjustment, inflation will continue to arbitrarily redistribute tax burdens across households and distort saving and investment decisions.

You can explore these scenarios using the same tool we used for this note. The Capital Income version of our tax-transfer calculator allows you to configure an individual's income profile (including labour income, interest income, and earnings from a capital gain asset) and see the resulting effective tax rates. We encourage you to use it to test the scenarios described above and to explore others that are relevant to your own circumstances or research.

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