Tax Facts

A knowledge-based series by the Tax and Transfer Policy Institute

What is the Capital Gains Tax?

What are capital gains?

In simple terms, a capital gain arises when an asset increases in value. It is distinct from the regular revenue that an asset produces.

The analogy of the fruit tree illustrates this distinction. The 'asset' is the fruit tree itself, the rise (or fall) in value of which gives rise to a capital gain (or loss). The revenue is the fruit that the tree bears on a regular basis.

In our economy, common examples of assets that generate both capital gains and revenue are shares in companies and rental properties.

For shares, the rise in value of the stock is the capital gain whilst the regular dividends are the revenue.

For rental properties the rise in value of the property is the capital gain whilst the regular payments by tenants is the revenue.

These are stylised examples. In reality the distinction in Australia's tax system between what is 'capital' and what is 'income/revenue' is important, complex and, accordingly, a rich area of litigation.

Why tax capital gains?

The main reason for taxing capital gains is to promote horizontal equity – that is, the principle that people with equal ability to pay should pay equal tax **[see our related tax fact on Principles of Tax System Design]**.

If capital gains were not taxed, then an individual earning all or most of her income from capital gains would be better off compared to someone earning only wages.

This was one of the main justifications for Australia introducing a Capital Gains Tax in 1985. As ownership of capital was concentrated in higher wealth individuals, not taxing capital gains was seen as undermining the progressivity of Australia's personal income tax system. In addition, capital gains were at the core of many tax avoidance arrangements as people sought to characterise other forms of income as 'capital' income.

Designing a capital gains tax

Not all countries tax capital gains or seek to tax them comprehensively. New Zealand, for example, has no broad-based system for taxing capital gains. It does, however, tax some capital gains as part of their ordinary income tax system. Extending capital gains was a recommendation in 2019 of the New Zealand Tax Working Group **[1]**.

The majority of countries, like Australia, that have chosen to introduce systems for taxing capital gains, are faced with a number of key design considerations.

Which assets should be taxed?

Broad based taxes (i.e. those with few exceptions) are desirable **[see our related fact sheet Good Tax Policy: Broadening the Tax Base and Lowering the Rate]**. Whilst this is equally true when designing a system for taxing capital gains, most systems around the world exclude certain classes of assets.

In Australia, the biggest exclusion is capital gains earned from the family home. In Australia, the exemption of the family home from CGT is the single largest 'carve out' from Australia's tax base, representing around $42.5 billion in foregone revenue in 2019-20 **[2]**.

Also, foreign residents are only taxed on a limited class of Australian assets relative to Australian residents. Notably, they are only taxed on the sale of Australian land or land rich assets (e.g. shares in a company that owns Australian land). This reflects commonly accepted international tax principles around how taxing rights are shared between countries.

Another notable exclusion from the taxation of capital gains in Australia is assets owned before the introduction of CGT in 1985. Whilst not part of the original draft design of the CGT, this exemption reflects the political challenges associated with introducing a new tax.

When should capital gains be taxed?

There are two basic approaches to when capital gains can be taxed – as they are accrued or when they are realised. The accruals approach is theoretically attractive as it would ensure that capital gains are taxed as they are earned, like other forms of income. However it has little support in practice, with most countries, like Australia, taxing capital gains when they are realised (when an asset is sold). An accruals approach presents significant challenges. It would be administratively burdensome as it would require asset valuations on an annual basis. It may also be difficult for taxpayers to pay any liability as they may not have the funds available. Italy tried to implement an accruals approach to taxing capital gains in 1998 but this only lasted a few years.

One of the key criticisms of taxing capital gains when they are realised is that it creates a 'lock in' effect. That is, taxpayers have an incentive to hold onto an asset longer than they otherwise would in order to avoid paying the tax.

At what rate should capital gains be taxed?

In Australia, the taxation of capital gains forms part of the broader income tax system. In this way, capital gains are not taxed separately but are simply added to other forms of income and taxed at the taxpayer's marginal tax rate. However, for individuals, only half the capital gain is taxed if the asset is held for more than 12 months. Why is this?

This was not the approach when CGT was introduced in 1985. Originally, capital gains were calculated as the difference between the purchase and sale price of an asset, with the cost of purchasing adjusted for inflation. Indexing in this way ensured that only the real gains (and not the nominal gains, which include inflation) from an asset were taxed (a dollar in 1990 is not the same as a dollar today!). A less well known feature of the original rules is that it also included an averaging option which allowed taxpayers to apply a marginal tax rate as if the gain had been spread over a number of years. Indexation and averaging were removed in 1999 when the present fifty percent discount method was introduced. This new approach to dealing with the difference between the nominal return and the real return was introduced at a time when inflation was slightly higher than it is today and in order to promote greater economic activity:

> *There is a need to enliven and invigorate asset management, to stimulate greater participation by individuals in investment, and to achieve a better allocation of the nation's capital resources* **[3]**.

Future policy considerations

Today, the concessional treatment of capital gains, and the implications it has for horizontal equity in the Australian tax system remains a live policy issue. The TTPI's own work on **the taxation of savings** suggests it might be time to consider a more fundamental shift in the way Australia taxes capital gains and other forms of investment income. That paper suggests Australia should consider taxing all such forms of income at a single, consistent rate similar to the approach adopted in a number of Scandinavian countries.

TTPI appreciates the research assistance provided by Lucas Rutherford for the preparation of this Tax Fact.

[1] Working Group 2019, **Future of Tax: Final Report**, New Zealand Government, Wellington

[2] Department of Treasury 2020, **Tax Benchmarks and Variations Statement**, Commonwealth of Australia, Canberra

[3] **Review of Business Taxation, A Tax System Redesigned, More Certain, Equitable and Durable, Report** (1999), Australian Government, Canberra

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