School of Taxation & Business Law (Atax), UNSW Sydney

School of Taxation & Business Law (Atax), UNSW Sydney

School of Taxation & Business Law (Atax), UNSW Sydney

Monash University and School of Taxation & Business Law (Atax), UNSW Sydney

Department of Economics, Queen's University

University of Sydney Business School

Faculty of Law, University of Sydney

School of Taxation & Business Law (Atax), UNSW Sydney

School of Taxation & Business Law (Atax), UNSW Sydney

Faculty of Law, University of Oxford

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# Editorial

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This special issue is devoted to Professor Chris Evans (School of Taxation and Business Law (TaxBL), 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, [illegible]

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

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# 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.

capital gains, compliance, complexity

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

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

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,

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, RitchC x

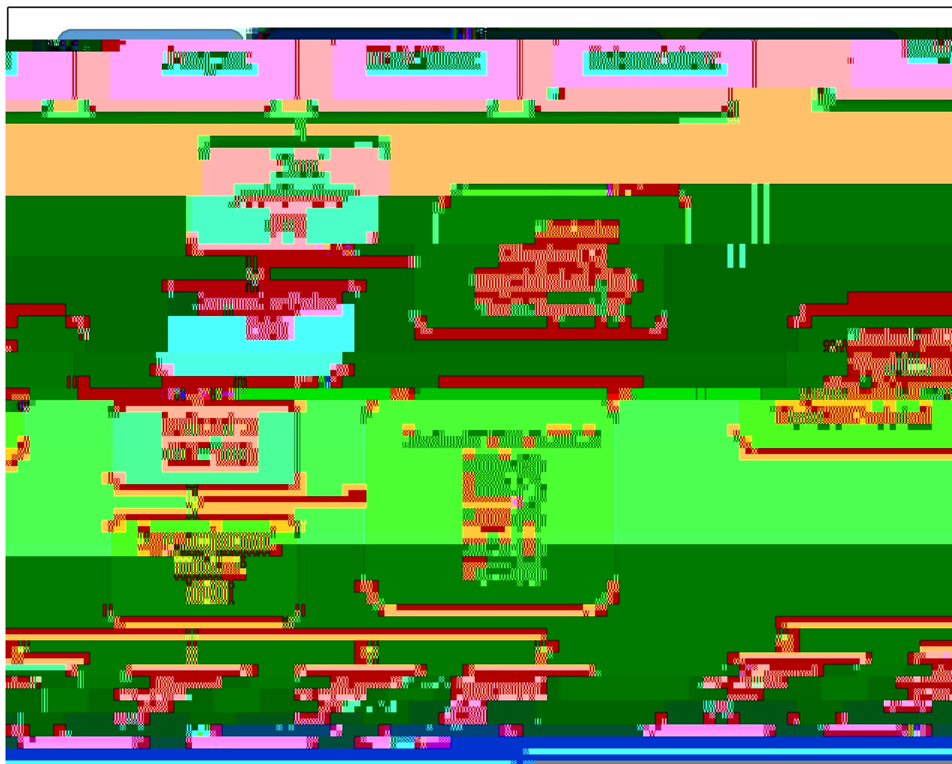
early work, Evans accepted that complexity as the cost of equity. As his compliance work correspondingly observes, however, complexity drives up compliance costs. Perhaps recognising that relationship inspired Evans to contemplate tax simplification. As with capital gains taxation and compliance costs,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

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



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.

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

* Analysis techniques may be used for more than one method

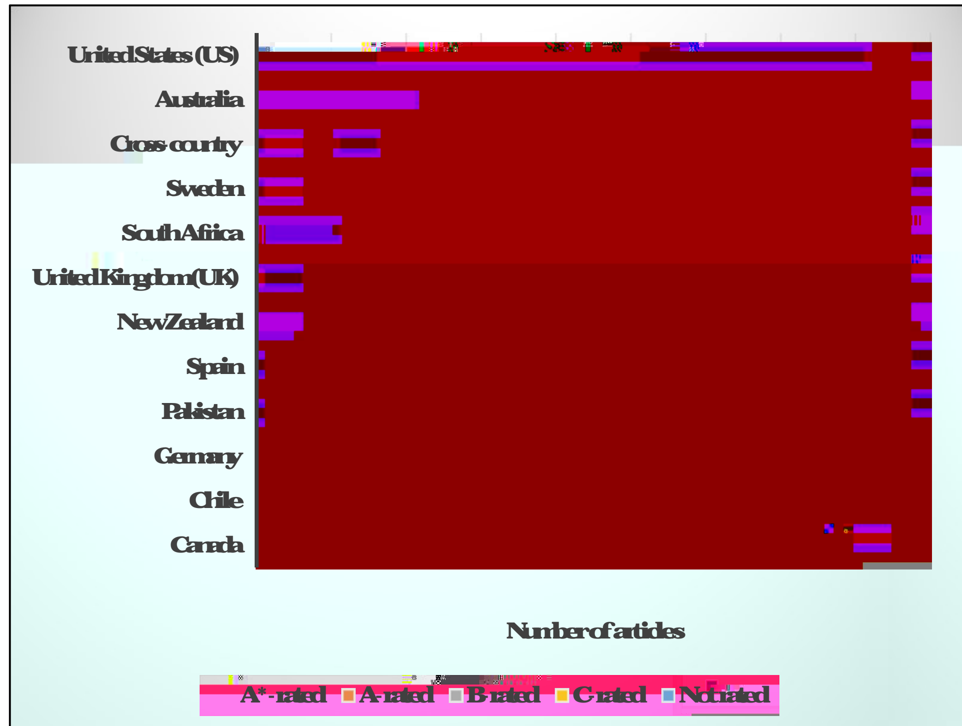
Each of the research design constructs are defined (for the purposes of this study) below, and were used as the basis for analysing the articles into the different research design constructs:

Historical research design – involves c lvne i

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

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

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




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.

Elasticity[7] 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

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.

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

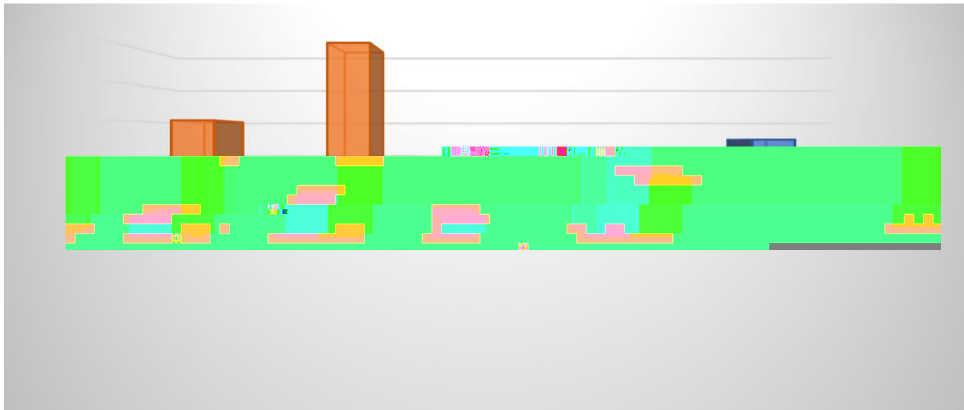


Figure 6 illustrates that 58% of the articles followed an experimental research design process. Twenty-two per cent used a descriptive research design process and 20% used a historical research design process. The prestige journals (A*, A and B rated journals) appear to have published articles that use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

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

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.

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.

For completeness, persons who have authored more than one of the analysed articles are

Hubbard, G 2015, 'Taking capital's gains: Capital's ideas and tax policy in the twenty-first century', National Tax Journal, vol. 68, no. 2, pp. 409-424.

Jacob, M 2018, 'Tax regimes and capital gains realizations', European Accounting Review, vol. 27, no. 1, pp. 1-21.

Meer, S H 2013, 'Canons of taxation in economics', Owlcation.com, 21 October, https://owlcation.com/social-sciences/Canons-of-Taxation-in-Economics (accessed 29 June 2018).

Minas, J & Lim, Y 2013, 'Taxing capital gains: Views from Australia, Canada and the United States', eJournal of Tax Research, vol. 11, no. 2, pp. 191-215.

Moosa, I A 2018, Publish or perish: Perceived benefits versus unintended consequences, Edward Elgar, Cheltenham, UK.

Nguyen, D T, Tran-Nam, B & Grewal, B 2012, Effects of natural resource revenue sharing and investment arrangements on economic growth and poverty reduction in low- and middle income countries, Protocol, Evidence for Policy and Practice Information and Co-ordinating Centre, University of London.

| | | | |
|---|---|---|---|
| Capital gains taxes and the market response to public announcements in an indexation based tax regime. | Journal of Contemporary Accounting & Economics | 2012 | Clinch, G & Odat, M |
| Capital tax reform and the real economy: the effects of the 2003 dividend tax cut. !] um e s | American Economic Review | 2015 | Yagan, D |
| Clash of the deeming provisions: pre CGT concessions, tax consolidation and policy in the federal court | Australian Tax Forum | 2016 | Barros, C, Teo, E & Hinchliffe, S |
| Cross-base tax elasticity of capital gains | Applied Economics | 2016 | Jacob, M |
| Data as choice in capital gains realisation responsÚ | | | |

| | | | |
|---|---|---|---|
| [illegible] tax elasticity [illegible] | National Tax Journal | 2015 | Dowd, T, McClelland, R & Muthitacharoen, A |
| On the role of intangible information and capital gains taxes in long term return reversals | Financial Management | 2013 | Bhootra, A |

| | | | |
|---|---|---|---|
| **The effect of the timing and direction of capital gain tax changes on investment in risky assets** | **The Accounting Review** | **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** | **eJournal of Tax Research** | **2016** | **James, S & Maples, A** |

| | | | | | |
|---|---|---|---|---|---|
| Accounting & Finance | | 1 | | | |
| American Economic Review | | | | | 1 |
| Applied Economics | | 1 | | | |
| Applied Economics Letters | | | 1 | | |
| Australian Tax Forum | | 3 | | | |
| Contemporary Legal and Economic Issues | | | | | 1 |
| eJournal of Tax Research | | 2 | | | |
| European [illegible] | 1 | | | | |
| European Journal of Manag[illegible] | | | | | 1 |
| Financial Management / Journal of [illegible] a l LeAc [illegible] ic | | 1 | 1 | | |
| [illegible] in f Accounted | | 1 | | | 1 |
| Hofstra Law Review | | | | | 1 |
| Journal of Accounting and Economics | | | 1 | | |

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# 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.

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

Paul College of Business and Economics, University of New Hampshire, john.hasseldine@unh.edu (corresponding author).

Haile/US Bank College of Business, Northern Kentucky University, Fatemid1@nku.edu. The authors thank the participants at the Comparative Capital Gains Tax Conference held in Prato, 26-28 September 2017 and an anonymous reviewer for their helpful comments on earlier versions of this article.

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

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.

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 Ê t a aco a us iaco a

**Kadous and Magro (2001)**

| | |
|---|---|
| **Advocacy Scale:** | **Davis & Mason (1994)** |
| **Audit / Tax:** | **Tax** |
| **Students / Professionals:** | **Practitioners (mean 12 years exp)** |

**Bobek et al. (2010) (cont)**
**Case: Hobby Loss**

'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)

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

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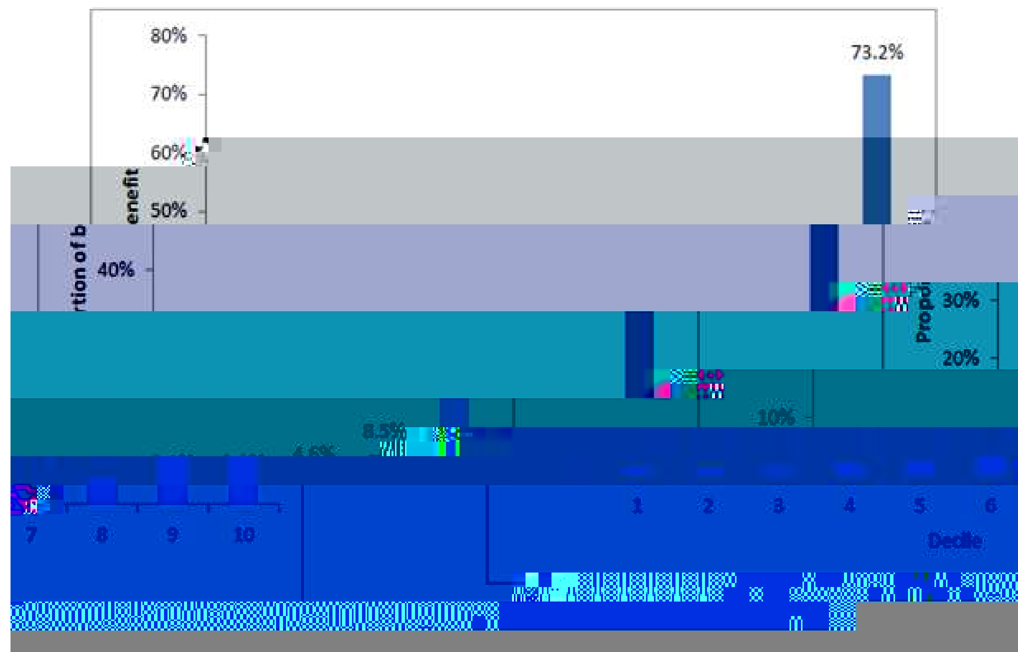
# Reforming Australia's 50 per cent capital gains tax discount incrementally

Brett Freudenberg and John Minas

## Abstract

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]




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 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

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]

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

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 Kentuck.

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.

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

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

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

'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

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'.

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,

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.

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

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.

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

François Vaillancourt and Anna Kerkhoff


## 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:

| | | | | | | |
|---|---|---|---|---|---|---|
| 1972 | $351,897 | $175,939 | na | 0.9% | na | na |
| 1975 | $1,065,321 | $476,213 | na | 1.6% | na | na |
| 1980 | $5,944,367 | $2,836,274 | na | na | na | na |
| 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 | 2,4[illegible] | 3.3% | 15.6% | 10.8% |
| 2005 | $33,838,117 | $17,641,498 | 1,[illegible] | [illegible] | [illegible] | 9.2% |
| 2010 | $29,287,705 | $16,814,504 | [illegible] | [illegible] | [illegible] | [illegible] |

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

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.

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

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 RRSP.

| | | | |
|---|---|---|---|
| 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

| | | | |
|---|---|---|---|
| 1972 | 84% | 86% | 0.2% |
| 1980 | 37% | 37% | 1.4% |
| 1990 | 31.6% | | |

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

| | | | | * |
|---|---|---|---|---|
| 1990 2095 | 1,625 | 2,390 | 695 | 4,710 |
| 1995 | 899 | 1,085 | 405 | 2,389 |
| 2000 | 1,3 25 | 1,890 | | |

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.

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 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 usM ! riimeuim m

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

(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,

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

Kerrie Sadiq and Adrian Sawyer

## 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

In particular, in the CGT context, Australia's politically controversial grandfathering clause, indexation versus discount, 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

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.

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]

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

> 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, be[illegible] the trouble from the revenue [illegible] 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 [illegible]

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

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> 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.

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 e

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 [illegible]

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.

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 [114]

rsonal income tax system is the fact that investments can be geared so as to

bring about interest deductions against the gains fr o the investment. To this end, the Henry Review o commended major o form in this area. It stated[115]

[109] Ibid 599.

[110]

[111]

(OECD, 2013) 35.

[112]

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

Ibid.

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

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

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 [illegible]