

Submission to the Senate Select Committee on the Operation of the Capital Gains Tax Discount

1. Introduction

Thank you for the opportunity to provide a submission to the Senate Select Committee examining the operation, effectiveness, equity, and fiscal impact of Australia's capital gains tax (CGT) discount. I am a Professor Emeritus of Taxation in the School of Accounting, Auditing and Taxation, part of the Business School at the University of New South Wales (UNSW), where I have taught and researched since my arrival in Australia in 1992. During my time at UNSW I was also (from 2000 to 2006) Director of the Australian Taxation Studies (ATAX) program, then the largest tax school in the world. Prior to my appointment at UNSW I was variously one of Her Majesty's Inspectors of Taxation in the UK's (then) Inland Revenue, and an Associate Director of a major tax consultancy based in London, in both cases focusing on CGT issues.

This submission draws extensively on over two decades of my Australian academic research and writing, alone and with collaborators. I consider that this empirical and conceptual research on the Australian CGT regime remains the most comprehensive in the field. I am also a foundation and current author/editor of *The Australian Capital Gains Tax Handbook*, now in its 16th edition and considered to be the foremost text in the field of CGT.

A full list of relevant references is contained at the end of this submission. I acknowledge that I have used Chat GPT to assist me in compiling this submission based upon my publications in the field. I am happy to confirm that all of the content properly and correctly reflects my own views based on the relevant research.

The CGT discount was introduced in 1999 upon the recommendation of the Review of Business Taxation (the Ralph Review). It replaced indexation and averaging for individuals and trusts and significantly altered the design and incentives of the CGT regime. The CGT discount was intended to encourage investment, compensate for inflation, and improve international competitiveness. After 25 years of operation, it is appropriate to reassess whether the discount meets Australia's policy objectives for an efficient, equitable, simple, and sustainable tax system.

My research, including longitudinal examinations of taxpayer behaviour, distributional effects, tax expenditures and compliance costs, demonstrates that the CGT discount has produced outcomes that substantially diverge from its original policy intent. The evidence consistently shows that:

- the discount is inequitable in its distributional impact
- the discount undermines neutrality across asset classes
- the discount has contributed to tax planning, lock-in effects, and misallocation of capital
- the revenue cost of the discount is significant and growing
- the policy rationale for a flat 50 per cent discount is weak when tested against empirical data.

In summary, the evidence from this body of work demonstrates that the 50% CGT discount introduced in 1999 has produced significant inequities, inefficiencies, revenue losses and compliance burdens, while failing to meet the principles of a well-designed tax system.

These points are amplified in the following analysis, based upon most of the Committee's Terms of Reference (though not necessarily in the same order as provided by the Committee). Item (e) of the Terms of Reference (The use of the CGT discount by trusts) is not specifically addressed.

2. Terms of Reference (a) and (d): Distributional and Equity Impacts of the CGT discount

Much of my work (for example, Evans, 2000; Evans, 2002; Evans 2004; Evans 2005; Evans, Lim & Minas 2015; Minas, Lim & Evans 2018), along with that of most other researchers, has repeatedly shown that capital gains—and by extension, the CGT discount—are highly concentrated among high-income taxpayers. The top decile of income earners consistently realises the majority of capital gains. The discount therefore functions as a regressive tax expenditure, eroding vertical equity. It also significantly offends against the principle of horizontal equity, providing preferential treatment for one form of income (the realisation of capital gains) as opposed to other forms of income (for example, earned income, business income, rents, interest and dividends). Further, intergenerational equity concerns arise as the discount inflates asset prices, particularly for housing. Younger and lower-income Australians face steeper barriers to asset accumulation, while older and wealthier cohorts disproportionately benefit.

Moreover, as shown in Davies and Evans (2024) the interaction of the main residence exemption with the CGT discount compounds this regressivity: the discounted taxable portion of gains on investment property is preferentially taxed, while owner-occupied gains are fully exempt, delivering the strongest concessions to high-value households. As a result, the combination of these two unprincipled and very expensive tax expenditures (costing an estimated \$47.5 billion in 2023-24, including \$25 billion attributable to the discount component) fails to correctly target housing affordability or home ownership and delivers the greatest benefit to wealthy property owners in high-value urban markets.

The CGT discount also interacts with negative gearing involving full interest deductibility and leveraged investment strategies to turbo-charge demand involving speculative investment in property and produce structural inflationary pressure on housing prices (Minas, Lim, Evans and Vaillancourt, 2021).

3. Terms of Reference (b) and (c): Economic Efficiency

My work has found little empirical evidence that the discount has produced measurable increases in productive investment. Studies conducted in the 2000s and 2010s reveal no strong correlation between the discount and increased entrepreneurship, employment growth, or innovation activity. Moreover, the discount overcompensates for inflation. Indexation was designed to remove only the inflationary component of nominal gains; the fixed 50% discount can exceed inflation by a wide margin, particularly in low-inflation environments. This has resulted in over-generous tax treatment of long-term capital gains relative to other forms of income.

The CGT discount distorts investment decisions by favouring capital gains over other income forms. Such preferential treatment encourages tax-motivated behaviour, including income re-characterisation and the timing of asset disposals.

The discount also exacerbates lock-in effects and leads to a misallocation of capital. Taxpayers defer realisation to maximise the benefit of the discount or to manage taxable income in low-rate years. This reduces asset mobility and contributes to suboptimal capital allocation. Evans, Minas and Lim (2018) provide the first Australian elasticity estimates of capital gains realisations. Their results indicate a realisation elasticity below 1, meaning that reductions in the CGT rate do not produce sufficient behavioural offsets to avoid revenue loss. As a result, the introduction of the 50% discount in 1999 resulted in significant revenue loss, not revenue neutrality or gain, contradicting predictions of the time. The discount therefore does not significantly increase market liquidity, encourages speculation and rapid turnover in certain asset classes and distorts investment allocations toward property and leveraged assets, where gains can be partly sheltered.

As Evans, Minas and Lim (2015) argue, the 50% discount arbitrarily privileging capital gains over wages, interest and other forms of income creates opportunities for income re-characterisation, raising integrity risks.

4. Terms of Reference (h): Any Other Related Matters

Complexity and Compliance Costs

Although the discount was intended to simplify the CGT regime by replacing indexation and averaging, my empirical research (for example, Evans 2004; Evans 2005) shows that overall CGT complexity and compliance costs have not materially decreased. Taxpayers still face substantial complexity in applying discount eligibility criteria. Professional fees associated with CGT compliance remain high, and the regime's complexity continues to impose disproportionate burdens on small investors and unrepresented taxpayers.

Fiscal Sustainability

The CGT discount is among the largest tax expenditures on the Commonwealth budget. Its cost has expanded significantly over time due to growth in asset markets and increased use of trusts and pass-through structures. My analysis suggests that the fiscal impact of the discount is not commensurate with any proven economic benefit. Adjustments to the discount rate, or a reversion to an inflation-adjusted model or one that provided a relatively modest tax-free threshold for capital gains could materially improve budget sustainability without undermining investment.

5. Options for Reform

Drawing directly on my reform proposals (Evans, 2004; Evans, 2005; Evans, Minas and Lim, 2015; Minas, Lim and Evans, 2018; Davies and Evans, 2024), a principled CGT reform package would include the abolition of the CGT discount and its replacement with (ideally) a non-cumulative Annual Exempt Amount (AEA) (the modest tax-free threshold alluded to immediately above). The advantages of such an approach are that it would lead to:

- an improvement in the equity of the CGT regime, as relatively low-income taxpayers with occasional and relatively small capital gains would be protected while high-income taxpayers with relatively more frequent and larger capital gains would pay tax appropriately;
- an improvement in the efficiency of the CGT regime as a result of reduced distortions and misallocations of capital;
- a simplification of the CGT regime and tax compliance as a result of the use of a straightforward threshold instead of the discount calculus; and
- positive and significant revenue outcomes.

8. Conclusion

Australia's CGT regime is now 40 years old. As I wrote in 2005, on its twentieth anniversary, the tax "shows signs of entering adulthood still burdened with the problems of youth". Now in relative middle age, the regime has still not provided a mature approach to the sensible taxation of capital gains, and the 50% CGT discount is perhaps the most blatant weakness evident in the regime. The weight of empirical evidence and academic analysis, much of it identified in this submission, demonstrates that the 50% CGT discount is inefficient, inequitable, costly, and structurally distorting. It does not deliver on its promised objectives and interacts adversely with other parts of the tax system, producing, most notably, an adverse impact on housing. This Senate Inquiry presents the best opportunity in decades to correct those enduring flaws. The Committee has a valuable opportunity to reassess the discount's role within the broader tax system and consider reforms that would help to realign the CGT regime with principles of fairness, efficiency, and sustainability.

I welcome the opportunity to provide further evidence or appear before the Committee.

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