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Taxing capital gains – views from Australia, Canada and the United States

John Minas* and Youngdeok Lim**

Abstract

This paper analyses a series of interviews, undertaken in Australia, Canada and the United States, with capital gains tax (CGT) experts on the preferential taxation of individual capital gains. The interviews explored their views on the taxation of capital gains in their jurisdictions. The interviewees were from academia, government advisory organisations and private practice. This paper focuses on two thematic areas covered in the interviews: the level of convergence or divergence of the experts' views on the benefits, disadvantages and need for CGT rate preferences and the experts' views on how the individual CGT should be reformed.

Key words: Capital Gains Tax, Semi-structured in-depth interviews, Australia, Canada and the United States

1. INTRODUCTION

This paper is based on a comparative research project exploring capital gains tax for individual taxpayers in Australia, Canada and the United States. We present the results of a qualitative study on taxing capital gains for which a number of experts in each individual country were identified and interviewed. These three countries were chosen as they are comparable OECD tax jurisdictions, which all offer a preferential rate for personal capital gains. The preferential rates available to taxpayers in these countries seem to be at odds with much of the literature, which describes taxation of capital gains at full rates as the tax policy ideal – although this view is not universal. The apparent discrepancy between the theory of taxing capital gains and the practice in each of the three countries was one of the motivations for this study.

This paper focusses on two thematic areas discussed in the interviews: the advantages and disadvantages of CGT rate preferences and how to reform the individual CGT in the country where the interviewee is based. One of the principal motivations for the research project was to identify the areas of consensus and disagreement on some of the main issues in taxation of capital gains for individual taxpayers. Another motivation for the research was the fact that the three jurisdictions offer rate

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preferences for capital gains, despite the view in the literature that such preferences do not represent good tax policy.

Arguably, one of the most controversial policy issues for tax systems generally is how to treat capital gains for tax purposes.[1] On the specific issue of the rate at which to tax capital gains, two broadly opposing views have emerged. One of these views holds that in accordance with Schanz-Haig-Simons comprehensive income concepts[2] and in the interests of overall tax system integrity, capital gains should be subject to the same rate of tax as ordinary income. A recurrent argument in the literature against CGT rate preferences refers to the incentive for arbitrage that they can create.[3] Arbitrage in this context describes taxpayers attempting to arbitrarily convert ordinary income into capital in order to take advantage of the rate differential between capital gains and ordinary income. A negative consequence of this arbitrage activity is that, if it is successful, it causes revenue leakage, which in turn requires an increase in tax rates on ordinary income.[4] The literature demonstrates that the ability to raise revenue is not the essential role of a CGT; rather, it is, intended to constitute an integrity measure for tax systems generally, where opportunities for re-characterisation of income are eliminated.[5]

The opposing view is that capital gains should be taxed at preferential rates relative to the tax rates on labour income.[6] A more controversial view is that capital gains should not be taxed at all.[7] The case for preferential CGT rates is 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'. However, arguments for preferential CGT encouraging risk are much more prevalent in the popular debate than in the economics literature.[8] The literature is critical of capital gains preferences as incentives for risk taking since they are untargeted and, as a result, provide incentives for non-risky CGT assets as well.[9]

In the Australian context, the recommendations of the 2010 Henry Review are considered relevant to this research given that one of the review's recommendations was to increase the rate of CGT, by reducing the level of CGT discount from 50 to 40 per cent.[10] This was part of one of the review's broader recommendations for a

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[1] Reuven Avi-Yonah, Nicola Sartori and Omri Marian, *Perspectives on Income Taxation Law*, (Oxford University Press, 2004) 87.

[2] Under which income is the total accretion to wealth over a period of time consisting of monetary increase in wealth plus imputed income and consumption expenditure for the time period.

[3] See, eg, Chris Evans, 'Curing Affluenza?: A Critique of Recent Changes to the Taxation of Capital Gains in Australia' (2000) 23 University of New South Wales Law Journal 299,302.

[4] Leonard Burman, The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed, (Brookings Institution Press, 1999), pp. 80-81.

[5] Chris Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?' (2002) 5(1) Journal of Australian Taxation 114, 118.

[6] A summary of some of the arguments for and against taxing income from capital at lower rates than income from labour can be found in: John Freebairn, 'Personal Income Taxation' (2012) 31:1 Economics Papers 18, 19.

[7] See, eg, Bruce Bartlett, 'The Case for Ending the Capital Gains Tax' (May-June 1985) Financial Analysts Journal, 23.

[8] Jane G. Gravelle, The Economic Effects of Taxing Capital Income (MIT Press, 1sted, 1994), 68.

[9] Noel Cunningham and Deborah Schenk, 'The Case for a Capital Gains Preference' (1992-93) 48 Tax Law Review 319, 374.

[10] Review Panel, *Australia's Future Tax System: Report to the Treasurer – Part One: Overview* (2009).

savings income discount of 40 per cent which was to apply to various other forms of passive income. The issue of how to tax capital gains is topical as evidenced by the recommendations of the Henry Review, which–if adopted–would have resulted in an effective CGT rate increase.[11] In the United States, a maximum rate of 15 per cent was introduced by the Bush administration. Although the maximum US CGT rate of 15 per cent is highly preferential, relative to the highest tax rate on ordinary income of 35 per cent, the 2010 expiry of these preferential CGT rates has since been extended by President Obama.

The paper draws on a selection of quotes from the interview data. Quotes have been included where they are considered to be representative of the views of several interviewees or because they are considered to be particularly well expressed views. Given the relatively small sample size and the fact that the research is qualitative, it is not considered appropriate to undertake any in-depth quantitative analysis of the interview responses. However, the paper includes a summary of some of the interview responses for the purpose of providing an overview. Interestingly, despite the fact that Australia, Canada and the United States each offer a CGT rate preference for the taxable capital gains of individual taxpayers, we find that preferential rates for capital gains are generally considered inappropriate and that the retention of capital gains preferences in the three countries surveyed is due mostly to political considerations. We conclude that, if the collective views of the experts in the interview sample were considered by policymakers, taxing capital gains at ordinary income rates would be a tax reform goal in each country.

This study is an original contribution to the literature as it is, to our knowledge, the first attempt to analyse the views on taxing capital gains from experts by way of a qualitative approach. One of the justifications for the study is the need to assess how closely aligned the taxation of capital gains in each of the three countries is with the views of capital gains tax experts. Whilst on the one hand, each of the three jurisdictions taxes capital gains realised by individual taxpayers at preferential rates, on the other, much of the literature on taxation of capital gains refers to the need to tax capital gains at full rates.

The remainder of the paper is organised as follows. Section 2 is a brief discussion of CGT and CGT preferences in each of the three countries. Section 3 develops the research questions on the two themes of the paper separately and describes the interview design. Section 4 presents the responses from each of the three jurisdictions and Section 5 contains the conclusions on each theme and discusses the tax policy implications, limitations and possibilities for future research.

2. BACKGROUND

2.1 Capital Gains Tax in the Three Jurisdictions

In Australia, capital gains are not considered to meet the ordinary income concept and several Australian tax law cases have outlined the distinction between income and capital receipts. Before a CGT was introduced in 1985, most capital gains escaped taxation altogether. The current Australian legislative rules in the Income Tax

[11] That is, a reduction of the CGT discount from 50 per cent to 40 per cent is effectively a CGT rate increase.

Assessment Act 1997 define a number of CGT events[12] which are subject to the CGT rules. Australia takes a different approach to taxing capital gains compared to some other jurisdictions in that CGT events are not limited to the disposal of property. In Australia, it is net capital gains that are subject to tax and these net capital gains are aggregated with the taxpayer's other assessable income. Capital losses can only be offset against capital gains, not against ordinary income. When taxpayers are unable to utilise their capital losses in a particular income year, they are carried forward to future income years. If the taxpayer qualifies for the 50 per cent CGT discount, this is applied to their net capital gain.

In the United States, CGT applies when a capital transaction results in a capital gain. A capital transaction occurs when a gain or loss results from the sale or exchange of a capital asset. A capital asset is any property except a number of items prescribed by the Internal Revenue Code.[13] Capital gains and losses are either short-term or long-term[14] and these two distinct categories cannot be netted against each other. The current United States treatment of capital gains is to tax net capital gains under a rate schedule separate from that for ordinary income. This system allows for up to $US3,000 of capital losses to be offset against a non-corporate taxpayer's ordinary income, with any remainder to be offset against capital gains or carried forward to a future year when there are insufficient capital gains in the current year to offset. The United States has provided a preferential rate for capital gains for most of the time that the CGT has been in existence in that country. Presently, the maximum rate of capital gains tax in the United States is 15 per cent,[15] and the top marginal rate of tax on ordinary income is 35 per cent. Thus, the United States has the most preferential rate of CGT rate for higher-income earners, relative to ordinary income, compared to Australia and Canada.

From the time that CGT was introduced in Canada, capital gains have always been taxed on a partial inclusion basis,[16] with the rate of inclusion in income changing at various times. Currently, the inclusion rate is one half, meaning that only 50 per cent of taxpayers' capital gains are included in taxable income. In Canada, capital losses can only be offset against capital gains and the remainder can be carried back to the three preceding years or carried forward. This CGT regime in Canada is quite similar in its operation to Australia's CGT, with one of the main differences being that Australia does not allow for the carry back of losses.

2.2 Capital Gains Tax Preferences in the Three Jurisdictions

Australia, Canada and the United States all provide a rate preference for CGT payable by individual taxpayers. These three jurisdictions were chosen for the research because their tax systems can be seen as somewhat similar and they have all experienced at least one CGT rate change. A notable difference between Australia and the North American jurisdictions is the experience each has had with full rate capital gains tax regimes. The Australian CGT regime was one that taxed capital gains at full

[12] See *Income Tax Assessment Act1997* (Cth) div 104.
[13] IRC § 1221 (2012).
[14] Generally, capital gains are long-term where the taxpayer has held the asset for twelve months or more.
[15] The maximum CGT rate on collectables, however, is 28 per cent.
[16] A certain proportion of taxpayers' net capital gain is included in their taxable income.

rates initially.[17] Compared to the United States and Canada, Australia has the most experience of taxing capital gains at full rates, in terms of the proportion of time that a CGT regime has been in place in each country. Canada has, from the time CGT was introduced, always had a tax on capital gains that is lower than the tax rate on ordinary income. In the United States, capital gains were taxed at ordinary income rates between 1988 and 1990, with preferential rates in place during the remainder of the time that CGT has operated there.

Of the three jurisdictions, the United States has experienced the highest number of CGT rate changes. Canada has had, at various times, a CGT inclusion[18] rate of one half, two thirds and three quarters. Australia has experienced only one CGT rate change. The effective CGT rate change was achieved by changing from the previous system of including the entire net capital gain in assessable income, with an indexed cost base, to the current system of including 50 per cent of the net capital gain in ordinary income, without an indexed cost base.[19] The latter is the basic operation of the 50 per cent CGT discount, a provision that became operational in September 1999.[20] One of the requirements for a taxpayer to qualify for the CGT discount is that they have held the asset subject to the CGT event for at least 12 months.[21]

Canada seemingly has more in common with Australia than the United States in its approach to the taxation of capital gains realised by individual taxpayers. A historical similarity between Canada and Australia is the fact that, in both systems, capital gains were not part of the initial tax base.[22] A more recent similarity is that in Canada, taxpayers are only required to include half of a capital gain in their taxable income.[23] The Canadian system differs from Australia's in that a taxpayer is eligible for the 50 per cent CGT preference irrespective of the amount of time that the asset has been held prior to disposal. Although a minimum holding period requirement for a preferential, or more preferential, CGT rate can be somewhat arbitrary, the absence of one, as in the case of the Canadian CGT regime, might extend the availability of the preference to items that are arguably closer in character to ordinary income rather than capital.

In the American context, the Republicans have generally wanted to reduce capital gains tax rates whereas the Democrats have wanted to keep the rates closer to those on other income.[24] The preferential treatment of capital gains in the United States has reduced the overall progressivity of the American tax system and references to this fact can be found in literature from the last few decades.[25] In the Australian context, the current rate of preferential CGT appears to have bipartisan support. This is

[17] From September 1985 until September 1999, with the indexation of cost base allowed where the asset had been held for 12 months.
[18] In taxable income
[19] The indexation of cost base is, however, still available in the case of pre-21 September 1999 CGT assets. The taxpayer can elect to use either the discount or the indexation method, where they qualify for both.
[20] *Income Tax Assessment Act 1997* (Cth) div 115.
[21] *Income Tax Assessment Act 1997* (Cth) s 115-25.
[22] This is contrast with the United States where capital gains were taxable as income from when the taxation system commenced there.
[23] *Income Tax Act*, RSC 1985, c 1 (5th Supp.) s 38.
[24] Joel Slemrod and Jon Bakija, *Taxing Ourselves,* (MIT Press, 4th ed, 2008), 279.
[25] See, eg, Richard Musgrave, 'The Carter Commission Report' (1968) 1(1), *The Canadian Journal of Economics,* 159,162.

evidenced by the fact that in 1999, the Howard Coalition Government introduced a CGT rate preference[26] and the fact that in 2010, the Rudd Labor Government ruled out adopting the recommendation of the Henry Review to change the rate of CGT discount from 50 to 40 per cent.

Although CGT rate preferences can prevent the inflationary component of a taxable capital gain being subject to tax, they are clearly an imprecise way of achieving this.[27] Factors relating to specific design features of a particular tax system can also be relevant to the rationale for the preferential treatment of capital gains. For example, some of the interviewees in this research project referred to the fact that the United States lacks an income tax provision that integrates the corporate and personal tax system,[28] which in turn causes double taxation. It might therefore be considered that a preferential rate of CGT is an appropriate way of providing an adjustment for this. However, it is noted in the literature that a CGT rate preference does not completely eliminate the problem caused by the double taxation in the classical system; it only reduces its impact.[29] Furthermore, the literature notes that, if a CGT rate preference is considered necessary to reduce the double taxation of corporate stock, it should apply to this specific capital asset only.[30]

Professor Joel Slemrod, in his large-scale research on professional opinions about tax policy, surveyed 503 members of the National Tax Association in the United States to enable a comparison of how views have changed from 1934 to 1994.[31] Slemrod's 1994 survey of tax policy opinions included several questions concerened with taxing comprehensive income and capital gains. The question most closely related to the interview questions in this paper is '*Should capital gains be taxed at a lower rate than ordinary income?*' In the 1994 survey, Slemrod found that there was 32 per cent agreement with this question; the level of agreement by sector was 61 per cent in private, 26 per cent in government and 18 per cent in academia.[32]

3. RESEARCH DESIGN

3.1 Research Questions

This paper looks into two thematic areas: the advantages and disadvantages of CGT rate preferences and the broad question of how to reform the individual CGT in each country. In the first instance, theme one is considered according to the responses provided to the following two interview questions.

[26] The 50 per cent CGT discount.

[27] The indexation system used in Australia prior to the CGT discount and still available in some circumstances is a more precise way of achieving an inflation adjustment. In those situations where the indexation method is available to taxpayers, there is no inflation adjustment beyond the September 1999 quarter.

[28] Such as the Australian imputation credit system for franked dividends which achieves partial integration.

[29] Cunningham and Schenk, above n 9, 331.

[30] Burman, above n 4, 77.

[31] Joel Slemrod, 'Professional opinions about tax policy: 1994 and 1934' (1995) 48 *National Tax Journal* 121, 126.

[32] Ibid.

Question one: What do you consider to be the main benefits and disadvantages of CGT preferences?

Question two: Given the benefits of deferral that apply to capital gains and the ability of the taxpayer to effectively choose when and if they will realise a capital gain, are preferential rates for capital gains considered appropriate?

One of the purposes of question one was to compare the current thinking of CGT experts on CGT rate preferences generally and the specific preferences offered in their country. Although the focus of this question was on CGT rate preferences, respondents were still able to discuss other types of CGT preferences.

Question two was designed to complement question one. Most of the responses provided to this question gave a clear indication as to whether the interviewee was in favour of CGT rate preferences or not. In total, 14 respondents – a majority of those interviewed – responded that rate preferences for capital gains were inappropriate in light of the deferral benefits that applied. Four respondents argued that there was some justification for CGT preferences, whilst a further six either did not provide a conclusive answer to the question or referred to arguments both for and against CGT preferences.

As part of the interviews, another question related to CGT rate preferences was asked:

Question three: Is the case for retaining capital gains preferences due mostly to economic efficiency considerations, political considerations or a combination of both?

The response to question three may be partially dependant on the responses to the previous questions. That is, an interviewee who is of the view that preferential rates for capital gains do not have a strong tax policy foundation, might conclude that it is more likely that the reasons for them being a feature of the respective tax systems of each country are more related to political rather economic efficiency considerations.

The project was also concerned with the experts' views on how the taxation of capital gains might appropriately be reformed in their respective jurisdictions. On this point, the following interview question was asked:

Question four: How do you think that the capital gains tax system in (Australia/Canada /the United States) can best be reformed?

Question four was designed to allow the respondents the opportunity to summarise the main points discussed in their interview and speak about any other CGT issues that had not been covered by the previous questions. At the end of each interview, respondents were able to add any further comments or talk about areas that had not been covered. One of the justifications for question four is provided by the literature that identifies asking a final open-ended question as an approach consistent with inductive reasoning, it is considered that this approach has the potential to uncover ideas that might inform the research.[33]

[33] Margaret McKercher, *Design and Conduct of Research in Tax, Law and Accounting*, (Thomson Reuters, 2010) 159.

Although question four can be considered a fairly broad question, capable of generating a wide range of possible responses, it is nevertheless considered valuable to the study as a whole. Question four enabled the interviewees to talk specifically about what they saw as the priorities for reform of CGT in their jurisdiction. One of the advantages of the question is that it is free from bias and does not limit what respondents can address in their answers.

Question four was intended to be the most open-ended question asked in the interview; this was reflected in the diversity of interview responses as a number of new themes emerged.

3.2 Interview Design

The methodology for the project was individual, in-depth interviews with experts on the topic of capital gains tax. The interviews took place during 2011. As all the interviews were conducted in person, there were budgetary constraints on the number of locations where these could take place. For practical reasons, interview locations were selected in Canada and the United States where several experts were located. Consequently, the selection of interviewees was somewhat limited to the extent that there were locations where a lesser of number of experts were located which were excluded from this study. This is not considered to have too great of an impact on a qualitative study such as this one.

The selection of interviewees for the research resulted in 24 interview participants in total: 11 from Australia, eight from Canada and five from the United States. The interviewees were a mixture of tax academics, tax practitioners and tax experts in government advisory type roles. The distribution of interviewees by country and broad demographic group is shown in Table 1.

Table 1 - Distribution of interviewees

	Academia	**Tax practice**	**Government advisory**	**Total**
Australia	10	1	0	**11**
Canada	6	2	0	**8**
United States	0	1	4	**5**
Total	**16**	**4**	**4**	**24**

The breadth of the interview sample might have been improved had some interviewees from all three demographic groups been interviewed in each individual country, although this is not essential for a qualitative study. Ideally, interviewees would have included academics in the United States and people from revenue authorities or government advisory organisations in Australia and Canada. This would have increased the overall representativeness of the sample in each individual country. Nevertheless, the interviewees are a reasonably good sample of CGT experts. In the

case of the 10 Australian academics who were interviewed, six were either professors or associate professors; the majority had publications on CGT. The tax practitioners and government advisory experts were all identified as having a very high level of CGT expertise and were selected for interview based on their credentials. Some of these interviewees had publications on CGT and others had been identified as CGT experts for other reasons. The requirement for anonymity in this research project necessitates that information which could be used to identify specific interviewees is not presented in this paper.

Semi-structured in-depth interviews were used in the research project, although these were primarily based on a set of prepared questions. The interviews were not considered to be structured as they were not limited to an identical set of questions. The aim of the interviews from the outset was to identify themes and semi-structured interviews were considered to be the best way of achieving this. Interviewees were provided with a list of indicative questions prior to each interview.

The interview questions were considered open-ended rather than closed questions. The literature identifies open-ended questions as a typical feature of qualitative interviewing.[34] It is also considered that an open-ended interview approach is a way of maximising response validity, since there is a greater opportunity for respondents to organise their responses within their own framework.[35] Consideration was also given to informal conversational interviews, which the literature identifies as the most open-ended approach to interviewing.[36]

Quotes from interview responses included in this paper have not been attributed to individual respondents so as to maintain confidentiality, as was agreed to in advance of the interviews. A unique letter code has been assigned to the respondents quoted in the paper.

4. RESEARCH FINDINGS

4.1 Theme One – Capital Gains Tax Preferences

A summary of responses to question two by country are shown in Table 2.

Table 2 – Interview Responses to question two by country

	Yes	No	Inconclusive	**Total**
Australia	1	7	3	**11**
Canada	2	4	2	**8**
United States	1	3	1	**5**
Total	**4**	**14**	**6**	**24**

[34] Annette Grindsted, 'Interactive resources used in semi-structured research interviewing' (2005) 37 *Journal of Pragmatics* 1015-1035, 1021.

[35] Joel Aberbach and Bert Rockman, 'Conducting and Coding Elite Interviews' (2003) 35:4 *PS: Political Science and Politics*, 673, 674.

[36] Michael Patton, *Qualitative research and evaluation methods,* (Sage Publications Inc., 3rd ed, 2002) 342.

A summary of responses to question two by demographic are shown in Table 3.

Table 3 – Interview Responses to question two by demographic

	Yes	No	Inconclusive	Total
Academia	2	10	4	**16**
Tax practice	1	2	1	**4**
Government advisory	1	2	1	**4**
Total	**4**	**14**	**6**	**24**

4.1.1 Responses to Question One and Two from the Australian Interviews

Question one: What do you consider to be the main benefits and disadvantages of CGT preferences?

Question two: Given the benefits of deferral that apply to capital gains and the ability of the taxpayer to effectively choose when and if they will realise a capital gain, are preferential rates for capital gains considered appropriate?

The main disadvantages are…There are clear equity implications and…since capital gains form in an increasing percentage of income as incomes rise…the effect of it is quite regressive. The benefit accrues more and more…as your income rises, but perhaps a more important disadvantage is the economic distortions it causes by altering the efficient allocation of capital…ancillary to that is to take advantage of the distortions requires a lot of reorganisation of transactions which means there's a lot of deadweight losses...

(Respondent M on question one)

M's response is consistent with a view in the literature about the importance of horizontal and vertical equity in a tax system. Not taxing capital gains at full rates can lead to mismeasurements of income and, in turn, horizontal inequity.[37] In Australia, as well as in the other jurisdictions, capital gains are more highly concentrated at higher income levels, which allows for a lower effective tax rate amongst higher income taxpayers with more capital gains.

[37] Richard Krever and Neil Brooks, *A Capital Gains Tax for New Zealand* (Victoria University Press for Institute of Policy Studies, 1990) 44.

…it is inappropriate to have a CGT discount or an exclusion or a lower rate of capital gains than you have for other forms of income because…investors can choose when to realise their assets…so you do potentially get some game playing going on…

(Respondent N on question two)

I don't think you need preferential rates.

(Respondent R on question two)

I think that deferral is a big advantage and that preferential treatments in fact exacerbate lock-in factors… I think the deferral aspects on the whole outweigh the case for any sort of concessional treatment. Tax on a realisation basis is in itself a concessional treatment.

(Respondent S on question two)

Another respondent from Australia referred to the bunching problem. According to some of the literature, bunching is an overstated problem as most capital gains are derived by high-income taxpayers whose income is at the top marginal rate of tax regardless of whether they realise capital gains in a particular year.[38] Furthermore, the benefits of deferral can be seen as counteracting the bunching problem in the case of capital gains that are realised several years after the asset was acquired. In some cases, the deferral benefits may completely offset the bunching effect.[39] The same respondent stated that, although, in their opinion, lock-in could be a problem, they did not see a preferential rate CGT as an effective way to deal with the problem.

Another respondent from Australia referred specifically to the problem of very few capital gains made by non-residents being subject to Australian tax. The respondent referred to this as an inequitable approach to CGT in that foreign residents receive a 'capital gain holiday' in Australia whereas resident taxpayers are subject to CGT on the same type of gains.

As was the case for a number of Canadian respondents, several Australians referred to the incentives to re-characterise income into capital as a specific disadvantage of preferential CGT. In response to an interview question not quoted in this paper, some respondents provided examples of ways in which taxpayers had achieved such re-characterisation.

4.1.2 Responses to Question One and Two from the United States Interviews

I think the big benefit is probably in…not interfering with the realisations of capital gains, so the realisations response. The disadvantages…once you have a differential between capital gains and other assets, you start all this game playing… to turn one kind into another to transform income into a capital gains form. I think it leads to distortions in the kinds of assets you hold and it leads to a lot of gaming of the system…

(Respondent A on question one)

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[38] Richard Krever, The Taxation of Capital Gains, In *Income Tax A Critical Analysis*, (LBC Information Services, 2nd ed, 1996).
[39] Cunningham and Schenk, above n 9, 328.

Respondent A was of the view that there were better forms of saving and investment incentives than a CGT rate preference. This respondent also referred to previous CGT rate reductions in the United States being justified by policymakers on the basis of revenue gains. However, the respondent believed that the literature that estimates a large revenue gain as a result of a CGT rate cut is not very persuasive due to flaws in the econometric techniques used. Respondent A also referred to the potential for politicians to confuse increased CGT revenue from economic growth with that from taxpayers' response to CGT rate reductions. Although there may be some degree of responsiveness of capital gains realisations to lower CGT rates in the short run, there is a lack of empirical evidence of their responsiveness to rate cuts in the long run. If the revenue collected from capital gains is an important consideration, then the level of responsiveness of capital gains realisations to rate cuts needs to be large enough to compensate for the static revenue loss of the rate cut itself.

Probably not, I think they're pretty favoured as is. Relative to dividends they're favoured already because of deferral and exclusion at death…if you hold on to them until death you don't pay any tax. So exclusion cuts it by about half, exclusion and deferral itself cuts the rate by about half all by itself. I think there are other more efficient ways to give up revenue than the capital gains cuts.

(Respondent A on question two)

According to Respondent A, capital gains tax rate preferences lead to lost revenue. That is, the behavioural response to lower CGT rates is too low to compensate for the static revenue losses resulting from the lower rate. It is also implied in Respondent A's response to question two that capital gains realisations tend to be relatively unresponsive to CGT rate cuts in the long run. A number of empirical studies from the United States on the elasticity of CGT realisations to rate changes have reached this conclusion.[40] Respondent A further stated elsewhere in the interview that attempting to reform the effective CGT exclusion at death would be too difficult to deal with politically. The literature considers the failure to tax capital gains at death to be a large impediment to the sale of assets which increases with a taxpayer's age.[41]

About the only possible benefit….of preferential rates on capital gains is…to deal with the fact that the corporate income tax and the individual income tax in the US are not integrated particularly well and so we have a situation where some income is taxed once, some income is taxed twice, at both the corporate and the individual level, and then there is some income that's not taxed at all.

(Respondent B on question one)

I think that the two [benefits] I can see as having some justification are, one, the problem…with people being locked-in to assets and so I think the relief of lock-in, particularly if individual income tax rates are very high, is some justification for having the (capital) gains rate lower. Essentially you've got unrealised gains that are going untaxed and ordinary income that's going taxed and so probably the least distorting thing to do with the realised gains is to tax it somewhere in between….The

[40] See, eg, Leonard Burman and William Randolph, 'Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data' (1994) 84 *The American Economic Review* 794-809.
[41] Gravelle, above n 8, 125.

other piece is to the extent that some gains come from corporate profits and some of those corporate profits have previously been taxed at the enterprise level, that would produce a second level of tax which might lead to over-taxation of corporate enterprises relative to other businesses.

(Respondent C on question one)

The response of Respondent C is consistent with the literature on the lock-in effect. The lock-in effect describes taxpayers choosing to hold their capital assets that have appreciated in value, so that the CGT on the accrued capital gain can be deferred or altogether avoided.[42] The literature describes lock-in as an impediment to selling one asset and replacing it with another which has a higher pre-tax return.[43] According to the theory of the lock-in effect, taxpayers will be responsive to a lowering of the CGT rate and will choose to realise accrued capital gains once they consider the CGT rate to be acceptably low.

The deferral provides a preference even without a special rate, so in that sense, you're adding on to the favourable treatment of capital gains when you give a preference…. It is the deferral or it is the voluntary nature of realisations which means that you kind of get into the situation where if you have high individual rates and you don't have a preference, you're likely to have a lot of gains that might have been realised that aren't, then you sacrifice revenue and you keep people from keeping their portfolios in the form which is most beneficial to them, so you do produce deadweight losses when you do that.

(Respondent C on question two)

As a follow-up question, Respondent C was asked whether something less than full rate capital gains tax is the ideal. The response given to this question was:

…it really depends on the kind of system you have. If you insist on having very high top individual rates I think you have to have some preferential treatment of capital gains. I can imagine a situation where you can get the top individual rate low enough that you don't need that. In fact we did that here in 1986.

(Respondent C)

As was the case for Respondent B, Respondent C also referred to the absence of corporate integration in the US tax system as being a benefit of and reason for preferential CGT. Respondent C also argued that the optimal rate for CGT, in terms of maximising revenue, is a rate lower than that which applies to ordinary income.

A theme to emerge from the American interviews was that CGT should be considered in the context of the budget deficit that the United States was experiencing. A recurring suggestion was that CGT should be reformed as part of an overall tax reform package under which CGT rates were either increased or taxed as ordinary income and ordinary income rates were lowered. The purpose of this type of reform would be to increase overall tax revenue.

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[42] Alan Auerbach, 'Retrospective Capital Gains Taxation' (1991) 81 The American Economic Review 167.

[43] Lawrence Lindsey, Rates, Realizations and Revenues of Capital Gains, in M. Feldstein (ed), *Taxes and Capital Formation*, (University of Chicago Press,1987), 17-26.

4.1.3 Responses to Question One and Two from the Canadian Interviews

> *…preferential [CGT is]…intended to deal with the integration of taxation…at a corporate level together with the taxation of the shareholders…it doesn't seem appropriate that the full amount of the gain should be taxed when the shareholder disposes of the shares because the same income has effectively been taxed twice…. I think the primary disadvantage…is there's an incentive for taxpayers to…characterise one type of income as a capital gain rather than as the income it should be characterised [as].*
>
> (Respondent F on question one).

Respondent H referred to the incentives to re-characterise income into capital in response to a question on how previous changes to individual CGT in Canada had been justified. This response has been included here since it is considered relevant to the theme of question one and question two.

> *…there's a view that the tax rate on capital gains needs to be almost the same as the tax rate on dividends. The rationale is that there is…a set of corporate reorganisations you can do to convert dividends into capital gains or vice versa within a private, closely held corporation…and the Government's view has been that they couldn't do much about it. The argument was that, if you found that capital gains were getting too lightly taxed relative dividends, people would convert what would otherwise be dividends in a private corporation setting into capital gains or ...if dividends were more lightly taxed they would try and create a situation where it would be for tax purposes a dividend.*
>
> (Respondent H)

> *I'm not persuaded there are lots of benefits but [I] see lots of disadvantages. I'm not convinced…that [it] encourages entrepreneurialism… There are other things that drive… entrepreneurial motivations that are much more significant than the prospect of low rate on a gain at the end of it all, when they sell out… The disadvantages…there are vertical equity[44] disadvantages…and the complexity and the games that are played around the borderline… As soon as you've got those discrepancies between one kind of income or another one thing or another, people will fight over those battles and that creates a need for anti-avoidance rules…so those are the huge disadvantages.*
>
> (Respondent I)

Respondent I also referred to previous lifetime exemption for small businesses, for certain types of capital gains that previously operated in Canada. One of the remaining lifetime exemptions still applying in Canada is the exemption for shares in a Canadian-controlled private corporation. The respondent stated that the justification for this exemption appears to be to encourage the growth of Canadian small businesses. A criticism that the respondent provided for this type of justification was that it is not logical in policy terms, given that the exemption applies at the time of the

[44] The general concept of vertical equity is that taxpayers should be required to pay a higher rate of tax as their ability to pay increases.

shares being sold. It was the respondent's view that this policy creates an incentive to sell small businesses rather than grow them.

All the evidence is clear in Canada and other countries that capital gains are realised disproportionately by higher wealth, higher income individuals. Any sort of preference is [from a distributional perspective] somewhat odd… [There are] administrative compliance costs associated with re-characterisation of capital income as capital gain, which is another negative. And the benefits…the…behavioural response….savings decision, lock-in effect, inflation adjustment… risk taking, those are supposed benefits.

(Respondent J on question one)

The main disadvantages are that it's unfair and that it creates inefficiencies and it creates administrative problems and it makes the tax system a less effective instrument for redistributing income… The alleged benefits are that it reduces lock-in, reduces the bunching effect and compensates for inflation and encourages risk taking.

(Respondent K on question one)

Respondent K went on to say that, in giving capital gains preferences, governments have argued that they are necessary for encouraging risk taking and entrepreneurship, but in the interviewee's personal view, these arguments did not have any merits.

No; indeed the fact that you get…to defer it is an additional tax benefit. I mean it's an argument for taxing them at full rates. You've already given them preferential treatment by allowing people to defer the gain and you know, all that does is exacerbates…the lock-in effect.

(Respondent K on question two)

The case for preferences is pretty weak stuff, particularly where you've got some form of dividend imputation.

(Respondent J on question two)

A theme that emerged from the Canadian interviews was that many interviewees, including Respondents F, I and J, referred to problems with the borderline between income and capital and the incentives created for taxpayers to convert ordinary income into capital gains where preferential rates were provided for the latter. According to the literature, the arbitrary conversion of income into capital can be achieved through complex financial instruments designed to provide a cash flow similar to dividends or interest whilst classifying the receipts as something other than either dividends or interest.[45] Inequity and unfairness were also considered to be disadvantages of CGT preferences according to some of the Canadian respondents. One of the Canadian respondents described a benefit of preferential CGT as moving the tax base towards a consumption-type base.

[45] Avi-Yonah, Sartori and Marian, above, n 1.

4.1.4 Responses to Question Three

Question three: Is the case for retaining capital gains preferences due mostly to economic efficiency considerations, political considerations or a combination of both?

I don't think you can separate the two…

(Respondent D)

Political considerations…but when I say political considerations, I don't mean that there's a sentiment in the country. I just mean the political clout of wealthy taxpayers.

(Respondent K)

I think it's a combination…a lot of politicians have been searching…for the magic bullet…something we can do to cut taxes and not (lose) a lot of money…so they readily listen to these arguments that you can't really raise revenues with capital gains or you don't lose much when you cut them because of these realisation responses.

(Respondent A)

The answers to question three revealed an area in which there was a degree of consensus. Specifically, none of the respondents said that the case for retaining CGT preferences was due mostly to economic efficiency considerations. Australia had the highest proportion of respondents who said that CGT preferences were due mostly to political considerations, whilst the lowest proportion of respondents who said the same was in the United States.

Several of the Canadian interviews included some discussion of the influence of political considerations in setting the original rate of CGT, when it was first enacted in 1972. This was explained in terms of policymakers, at that time, perceiving that there would be difficulties in going from a zero rate of CGT to 100 per cent inclusion of capital gains in ordinary income. In this sense, the 50 per cent inclusion might have been seen as a n ecessary political compromise. One interviewee suggested that the CGT preference in the United States at the time may also have contributed to the decision by Canada not to tax capital gains at full rates.

A distribution of the answers to question three is shown in Table 4.

Table 4 – Interview Responses to Question Three

	Political	Both	Economic efficiency	Unanswered	Total
Australia	9	2	0	0	**11**
Canada	4	3	0	1	**8**
United States	2	3	0	0	**5**
Total	**15**	**8**	**0**	**1**	**24**

Although it is not the intention of this paper to undertake quantitative analysis of the results, it was noted that of the three demographic groups, academics had the highest proportion of respondents who answered that CGT preferences were due mostly to political considerations. Interviewees from government advisory organisations had the highest proportion who answered that they were due to a combination of political and economic efficiency considerations.

4.1.5 Conclusions on Theme One – Capital Gains Tax Preferences

An apparent theme from interview questions one and two was that the rate of tax on capital gains should be increased whilst the rates on ordinary income should be decreased. Several respondents stated that the tax rates on ordinary income and capital gains should be the same. Some respondents did not think that the rates of tax on capital gains should be increased. Responses to question three confirm the influence of political considerations on setting CGT rates.

The majority of respondents did not favour CGT rate preferences. This was apparent in many of the answers provided to the question about the advantages and disadvantages of CGT preferences, where most of the interviewees focussed on the disadvantages and some did not refer to any advantages of CGT preferences. One respondent referred to the case for taxing capital gains more heavily than ordinary income, rather than preferentially, given the benefits of deferral. Several interviewees cited the vertical equity disadvantages of CGT preferences and the fact that capital gains are realised disproportionately by higher income taxpayers. The literature describes vertical equity as taxation based on ability to pay which may be achieved by progressive rates of tax.[46] Several interviewees referred to administrative and compliance problems caused by CGT rate preferences.

Some respondents stated that a reduction in the magnitude of the lock-in effect was an advantage of preferential rates. One interviewee described reduced lock-in as of some relevance to an individual seeking to balance their portfolio, but not necessarily more efficient for the whole economy. This is consistent with some of the literature, which argues that lock-in does not require a remedy in the form of a CGT rate preference. One of the reasons given for this is that lock-in at the individual investor level is unlikely to have a significant effect on the overall allocation of capital, since there is enough capital that is not subject to lock-in.[47]

Although a reduced tax rate on capital gains is likely to reduce lock-in, the literature identifies other factors that may be more important in causing lock-in than CGT rates. One such example is the treatment of capital gains at death in the United States, which is said to be the primary cause of lock-in in that country.[48] The fact that a taxable capital gain does not arise at death also contributes to lock-in in Australia. However, the preference for capital gains at death in Australia is less pronounced than in the

[46] Paul Kenny, 'Australia's Capital Gains Tax Discount: More Certain, Equitable and Durable?' (2005) 2 *Journal of the Australasian Tax Teachers Association* 38, 40.
[47] Calvin Johnson, 'Taxing the Consumption of Capital Gains' (2008) 28 *Virginia Tax Review* 477, 501.
[48] Ibid 502.

United States, given that the cost base of an asset in Australia is not 'stepped-up' at death.[49]

Several interviewees referred to an incentive to characterise income as capital gains where the CGT rates are lower. According to one of the interviewees, in a self-assessment tax system, such as Australia's, taxpayers who have the means to engage in this arbitrage are effectively choosing their rate of tax. Clearly, there is a vertical equity problem associated with this as such a choice is not available to all taxpayers. Furthermore, it is most unlikely that the policy intent of a preferential CGT rate includes the facilitation of arbitrage and allowing taxpayers to choose a lower rate on income that would be taxed at ordinary rates in the absence of preferential CGT.

Several interviewees referred to the distributional impact of preferential rate capital gains as one of its disadvantages. That is, since there is a skewed distribution of realised capital gains towards higher-income earners, this same taxpayer demographic group enjoys the benefits of preferential rates at a disproportionately higher level than lower-income taxpayers do.

The responses of the interviewees collectively to the theme one questions confirms our initial view that capital gains rate preferences are at odds with much of the literature on taxing capital gains. It would appear that some of the claimed benefits are overstated or difficult to prove empirically, such as those about the positive effect on the economy, in contrast with some of the disadvantages, especially those related to the equity implications.

4.2 THEME TWO – REFORMING CAPITAL GAINS TAXATION

4.2.1 Responses to Question Four from the Australian Interviews

Question four: How do you think that the capital gains tax system in (Australia/Canada /the United States) can best be reformed?

By the removal of as many preferences as it is possible to sensibly remove without impacting on business creativity and growth and by the introduction of the tax free threshold and…. I would also get rid of the pre-85 exemption….

(Respondent N)

[49] The effect of the *Income Tax Assessment Act 1997* (Cth) s 128-10 is that in most cases, a capital gain or loss arising from the death of a taxpayer will be disregarded. A more important CGT implication in the event of death will be the treatment of the cost base of the inherited asset. Unlike the United States, which allows for a 'stepped-up' basis, in Australia, the cost base of the asset for the inheriting taxpayer is the same as the cost base of that asset for the deceased, as per the *Income Tax Assessment Act 1997* (Cth) s 128-15(4). The exception to this rule, under the *Income Tax Assessment Act 1997* s 128-15(4) is in the case of an inherited asset that was 'pre-CGT' when held by the deceased. In that case, the cost base for the inherited asset will be its market value, meaning that it effectively loses its CGT-free status on the event of death.

…get rid of pre-CGT assets.

(Respondent U)

…dealing with negative gearing…

(Respondent Q)

In response to question four, some interviewees in Australia referred to the need to reduce the complexity of the CGT system. It was suggested by one respondent that more input from tax practitioners should be allowed in formulating CGT policy and tax policy generally and that this would achieve a reduction in the complexity of the CGT provisions. The respondent appeared to be of the view that tax practitioners had a thorough understanding of the effect of proposed tax policy changes and that their input was not being given due consideration before the introduction of some of these changes. The respondent appeared to be arguing that parts of the CGT legislation had become unnecessarily complex and that such complex tax law changes could have been avoided if tax practitioners were allowed more involvement in the tax reform process and in particular the drafting of legislation.

The issue of 'grandfathering' of pre-20 September 1985 CGT assets[50] was considered to be problematic by several of the Australian interviewees. Respondents N and U were amongst those who proposed that the issue of grandfathered pre-20 September 1985 CGT assets be addressed. Their concerns are consistent with a view in the literature that grandfathering is a uniquely Australian CGT characteristic which has bedevilled the CGT since its inception.[51] The problem of grandfathering could have been avoided if Australia had followed the example of the Canadian CGT and implemented a valuation day system for CGT assets. Under such a system, the market value of the CGT asset on the nominated valuation day is its cost base or basis. The introduction of a valuation day system in Australia would eliminate the current grandfathered status of pre-20 September 1985 CGT assets from the valuation day onwards. Taxpayers with pre-20 September 1985 CGT assets may argue that implementing a valuation day system for these assets would constitute a type of retrospective tax reform. However, any gain on a pre-20 September 1985 CGT asset, which had accrued prior to enactment of a valuation day rule, would escape tax and this proportion of the post-19 September 1985[52] gain that is untaxed is effectively a CGT preference. It is therefore difficult to support the view that this type of valuation day system would be retrospective in its application.

4.2.2. Responses to Question Four from the United States Interviews

…getting rid of this rate structure and [implementing] an exclusion…I think we could afford to raise the capital gains tax rate, given our revenue needs without doing much harm to anything and we could raise some revenue…go back to the pre-Bush tax cut level of 20 per cent and maybe higher or its equivalent in proportional rates…Raise

[50] In Australia, a pre-20 September 1985 CGT asset (pre-CGT asset) is one which was last acquired before 20 September 1985. Once the asset is subject to a CGT event, it loses its pre-CGT status.

[51] Gordon Cooper and Chris Evans, *Cooper & Evans on CGT* (Thomson Reuters, 2nd ed, 2010) 8.

[52] Capital gains on pre-20 September 1985 capital gains assets are not subject to CGT in Australia because of the grandfathering rules that accompanied the introduction of CGT.

[CGT rates], make an exclusion and get rid of it entirely for owner occupied housing…. The foremost policy [factor] that I think should drive tax policy of any kind right now, at least in this country, is dealing with the deficit and I think raising taxes needs to be a part of that because it's just too hard to do it on the spending side.

(Respondent A)

Respondent A argues that an exclusion of a set percentage of capital gains from taxable income is a superior form of CGT in comparison to a separate rate schedule. If this reform were adopted, the individual American CGT system would bear a closer resemblance to those currently operating in Australia and Canada. It is clear that the respondent is of the view that CGT rates in the United States should be increased.

…just tax it as ordinary income and… [get] rid of a lot of other tax preferences and…[go] back to the kind of reform we had in 1986. You can have lower tax rates on all income….With capital gains, you have to fill out this whole schedule and…if you got rid of a lot of tax preferences you might get rid of a whole bunch of schedules.

(Respondent B)

I don't think it's just the capital gains tax but [in] our general system, I would prefer to see lower corporate individual rates and higher tax rates on capital gains and dividends, that is, higher tax rates on corporate income at the shareholder level and you know, preferably I'd like to see some form of accrual taxation either through taxation of gains at death or the… accrual taxation of tradable shares, I'm not sure which is the best way to go about that but I think that's going to be very hard to get in a political sense… So moving toward more accrual taxation, equalising rates on gains and ordinary income and bringing in the corporate rate I think are the kind of three legged stool of better taxation of capital income.

(Respondent C)

[If] they wanted to reduce the rate, they could reduce the rate without losing any revenue…if we went back to that it wouldn't be the end of the world.

(Respondent D)

These four responses to the question from the United States demonstrated divergence, particularly between those from respondents A and D, who appear to have differing views on the revenue effects of CGT rate changes. Respondent B suggested that a reform similar to that, which took place in the United States, in 1986, is required. In that year, the top marginal tax rate on ordinary income was reduced from 50 per cent to 28 per cent and the tax rate on capital gains was increased from 20 per cent to 28 per cent. Respondent C also suggests the same kind of reform without specifically referring to 1986.

Another of the respondents suggested the taxation of gains at death and he/she referred to this as a form of accrual taxation. The term *accrual taxation* in this context accurately describes the interviewee's reform proposal given that, in the event of death, no sale or exchange of the asset has taken place, as is generally required for a

capital gain or loss to occur under United States CGT law. The effect of such a reform would be to reduce the incentive to hold assets until death. An alternative would be to remove the stepped-up basis preference, which currently exists in the American system, and replace it with the capital gains treatment at death in the Australian system, in which the cost base of the asset stays the same when the taxpayer's heir inherits it.[53]

4.2.3 Responses to Question Four from the Canadian Interviews

On liquid investments, I'm quite happy with accrual taxation at full rates. Actually on all of it, I'd tax at full rates...I would never get elected

(Respondent H)

I think we ought to be eliminating the general preference for capital gains and… at the same time, eliminating the poor treatment of capital losses in the sense that only half of them are subject to tax and to the extent that we want to justify particular types of investment, we should have targeted rules but they do have to be appropriately targeted…

(Respondent L)

Respondent L's response is consistent with a view from the literature that attempting to encourage risk-taking by way of a CGT rate preference is target-inefficient.[54] One of the specific objections to such a preference is that it benefits investments that do not involve risk as well as assets that are non-productive or those assets which have an inelastic supply.[55]

I'd like full inclusions but…it seems that going back to the 75 per cent inclusion rate is politically feasible. We have… $500,000 capital gains exemption for small businesses… and farms…. I'd certainly get rid of that.

(Respondent K)

I think the capital gains tax system in Canada works fairly well….I think the deferrals we have now are more than sufficient and are appropriate. I don't see the need myself for more exemptions or preferences.

(Respondent F)

Respondent F did not seem to have any strong objections to CGT rate preferences relative to the other Canadian interviewees. Notwithstanding this, he/she did not support any further reduction of the CGT rate or the introduction of other forms of CGT preferences. This suggests that if policymakers consider a preferential CGT rate necessary, they should also consider the appropriate rate that should apply. This is especially important in the context of literature, which asserts that the preferential CGT rates lose revenue in the long run.

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[53] Under the *Income Tax Assessment Act 1997* s 128-15(4), the cost base of a post-19 September 1985 asset is 'the cost base of the asset on the day (the deceased) died.'
[54] Krever and Brooks, above n 37, 84.
[55] Ibid.

Of the three countries referred to in this paper, Canada is the only one that has not taxed capital gains for individuals at the same rate as ordinary income. The proportion of a capital gain that is to be included in a taxpayer's income has, at various times that the Canadian CGT regime has been in operation, varied between half, two thirds and three quarters. The fact that capital gains have been taxed at preferential rates in Canada might have contributed to the perception among some of the Canadian interviewees that taxing capital gains at ordinary income rates could be difficult to achieve in practice. That is, it might be that Canadian taxpayers have an expectation of preferential CGT rates due to Canada's taxing capital gains at less than full rates over the last four decades.

The responses from Canada indicate a diversity of opinion on the appropriate rate at which to tax capital gains. Whereas Respondent H argues for full rate CGT, Respondent K asserts that although, in his/her view, full rates are the ideal, 75 per cent inclusion may be more politically achievable. Respondent F on the other hand, thinks that the current system of 50 per cent inclusion works well. One of the Canadian interviewees referred to problems in defining realisations, citing corporate reorganisations as an example of situations in which definitional issues arise.

4.2.4 Conclusions on Theme Two

Most respondents spoke at length about their suggestions for reform of CGT in response to the final open-ended question. However, a small number of interviewees chose not to answer the final question as they were of the view that their ideas for reform had been covered in responses to the preceding questions.

It is evident that several Australian interviewees who spoke about the issue of grandfathering of 'pre-CGT' assets did not support this policy. The introduction of a valuation day would address the grandfathering problem and improve the CGT regime. The prospects of achieving this type of reform in practice are unclear.

It is arguable that borrowing against an asset is the equivalent to realising a capital gain and that it should therefore give rise to a taxable CGT event. If this view is considered correct, it diminishes the case for negative gearing. Negative gearing was referred to as another problem related to CGT rate preferences by respondents in all three countries.[56] Negative gearing is an issue closely related issue to preferential capital gains tax rates insofar as it creates an incentive for capital gains over other returns regardless of the economic efficiency of the investment.[57] The concerns of some of the interviewees about negative gearing in a preferential rate CGT regime were consistent with the literature on this topic.

Although taxation of capital gains on an accrual basis, for certain types of assets, was a reform suggested by some respondents, several interviewees were strongly opposed to accruals taxation of capital gains in any form, citing unfairness, liquidity and

[56] Although the term *negative gearing* is not in common use outside Australia, several respondents in Canada and the United States spoke about what would be considered the equivalent of negative gearing. In Australia, negative gearing allows taxpayers who have borrowed to purchase a CGT asset, to deduct from their assessable income, the excess of interest payments over taxable receipts, net of other deductible expenses.

[57] Burman, above n 4, 78.

valuation problems as some of the reasons they did not support such a reform. One of the respondents stated that they disagreed with proposals to use an accrual basis CGT for certain types of assets, such as publicly traded shares. It was their view that this would skew investment towards other types of capital gains assets that were taxed on a realisation basis and it would be difficult to see what the benefits of this type of distortion to investment incentives would be.

Several interviewees questioned whether a CGT rate preference was the best means of achieving some of the associated tax policy objectives[58] and some argued that, if such incentives were considered necessary, a better-targeted measure should replace a rate preference.

A qualification to all of the research findings detalied above is that the interviewee sample is arguably unbalanced, in part because of its size. For example, there were no interviews conducted in Australia or Canada with CGT experts in government advisory roles and no interviews conducted in the United States with experts from academia. However, the composition of the interviewee sample is not considered a significant limitation given that the research is qualitative rather than quantitative. According to the literature where interview-based qualitative research is undertaken, statistical conclusions should not be generalised to broader populations.[59]

5. CONCLUSION

5.1 Summary and Tax Policy Implications

In canvassing the opinions of CGT experts in the three countries, one of the purposes of the research project was to ascertain where the main areas of convergence and divergence were on issues associated with CGT for individuals, particularly those related to CGT preferences. Although there were some aspects of the interview responses that may be unique to the country in question, there were several areas of consensus across the three jurisdictions. Some differences of opinion arose in some of the interview responses, and this may reflect some of the difficulties and controversy associated with taxation of capital gains generally. Nevertheless, the research revealed several areas in which the interviewee population agreed. It is particularly noteworthy that despite the fact that each of Australia, Canada and the United States offers a CGT rate preference for the taxable capital gains of individual taxpayers, a significant proportion of the CGT experts interviewed were generally not supportive of such CGT rate preferences and were unconvinced as to their claimed benefits.

One of the United States respondents suggested the abolition of the separate CGT rate schedule in that country, to be replaced by a system of aggregating and taxing capital gains with taxpayers' ordinary income. The same interviewee suggested that a form of exclusion would be a superior method of providing a CGT rate preference. If such a change was enacted, it would bring the American system of taxing capital gains of individuals closer to those operating in Australia and Canada. This would be considered a worthwhile reform for the United States CGT system given the simplicity

[58] These might include objectives such as encouraging investment in new capital, increasing entrepreneurship and reducing the extent of the 'lock-in' effect in relation to capital gains realisations.
[59] McKercher, above n 33, 161.

benefits it would afford as well as the fact that it would facilitate a closer relationship between the taxpayer's tax rate on their ordinary income and their CGT rate, especially at the highest marginal tax rate. None of the Australian or Canadian interviewees suggested that a separate CGT rate schedule should replace the current CGT rate preference systems in those countries.

Some Australian respondents were critical of the grandfathered status of pre-20 September 1985 CGT assets. Grandfathering of CGT assets did not occur in Canada or the United States when CGT was introduced there, and it was originally intended that the Australian CGT system would use a valuation day system before a late and unexpected policy change. Australia's grandfathering of pre-20 September 1985 assets provided a windfall, in the form of preferential tax treatment, to taxpayers who held these assets at the time of the tax law change. In this context, it is unclear why Australia's 1999 50 per cent CGT discount was designed to apply to capital gains from assets that were acquired prior to the introduction of this reform. Preferences afforded to capital gains that are accrued are another form of windfall gain for assets purchased by taxpayers before the tax law change was introduced. Furthermore, extending the preference to accrued gains conflicts with one of the more common rationales for CGT preferences, that of encouraging new investment in capital.

The interviews, arguably, confirmed what appears to be the political imperative of retaining CGT rate preferences in all three tax jurisdictions. However, the interviews served to reinforce the point that the tax policy advantages and disadvantages of CGT preferences need to be considered on their own merits. If policymakers considered the collective views of the experts in the interview sample, the case for taxing capital gains at ordinary income rates would be, at a minimum, a longer-term tax reform goal in each country. This is notwithstanding the fact that some of the experts presented the case in favour of preferential CGT rates. Even where a preferential rate is considered necessary, it is our view that there should be objective and transparent tax policy reasons justifying the chosen CGT rate and that these should be reiterated whenever the CGT rate is changed.

Although some interviewees were of the view that an accrual-based CGT was feasible, there appeared to be a higher number who strongly opposed this type of CGT regime for practical reasons.[60] It is the authors' view that although accrual-based CGT is very unlikely to be introduced in Australia, policymakers should consider a system of deemed disposal, after a given number of years, for CGT assets in cases in which taxpayers have used negative gearing. Given that investors use negative gearing in anticipation of a capital gain, there is currently potential for a significant mismatch between deductions and taxable income in many individual cases, favouring the former over the latter. This will often be the case in those instances where a taxpayer chooses never to realise a capital gain for the asset in question. In these instances, the overall costs to the revenue are significant.

[60] It was noted in Australia by the Taxation Review Committee (Asprey Report) 1975 that 'the impracticability of taxing capital gains as they accrue is universally recognised: the tax can only attempt to deal with realised gains.'

5.2 Limitations and Future Research

The interviews primarily sought to discover more about the experts' thoughts on how to tax capital gains and their views on the rate preferences that are a feature of all three jurisdictions so that these could be analysed and compared. Notwithstanding the expertise of the sample, the conclusions in this paper need to be qualified in respect to the relatively small sample size and the demographic skewing that resulted from the sample used.[61] Another limitation is that, whilst the interviews sought the views of experts on how to best reform the CGT system in each country, it did not seek their views on the best means of achieving these reforms or specifically address whether the suggested reforms were achievable in practice. Nevertheless, numerous interview responses made specific references to potential political impediments to suggested CGT reforms.

If the recommendations of the majority of the interviewees are to be balanced with the political considerations that restrain tax reform generally, CGT rate reform for individual taxpayers should be concerned with increasing the effective CGT rate in each country so that more than 50 per cent of capital gains are taxable at all levels of income. Increasing the rate of CGT, whilst maintaining a rate preference relative to ordinary income, may constitute a second-best type of improvement to the current respective CGT systems. It would result in a compromise, which would to some degree, address the concerns expressed by the majority of the interviewees about current CGT rates being too low, with the apparent expectation from individual taxpayers of some form of CGT rate preference. Although we consider that this paper has made an original contribution to the literature by way of a unique methodology for the topic, we also consider that the project is conducive to further research using the same interview data, as there were several other themes discussed that were outside the scope of this paper. One such example is the experts' views on CGT preferences other than rate preferences, such as the use of the main residence exemption in Australia and the equivalent provisions in Canada and the United States.

[61] The use of a convenience sample necessarily requires that the research findings need to be qualified. That is, the research findings might have been different if the interviews were not restricted to the locations used in this project.