Chapter 12

INDEXATION, AVERAGING AND QUARANTINING OF LOSSES

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A case for reform

Current arrangements are complex, inequitable and distortive

12.1 The chapter reviews indexation, averaging and quarantining of losses and canvasses possible changes. The Review intends to assess the main design features of the capital gains tax (CGT) and to consider reforms that would make it more acceptable, while not compromising its overall contribution to the integrity of the taxation system. As the Government has indicated its intention to retain the CGT-free status of assets acquired before 20 September 1985, this feature will not be considered by the Review.

12.2 The current *indexation provisions* of the CGT mean that increases in the value of an asset, to the extent offsetting inflation, are exempt from taxation. This contrasts with other investment income. For example, interest payments contain a component which reflects inflation as well as a real return to the taxpayer. However, both components are fully subject to tax. In this regard capital gains are taxed more lightly than other forms of investment income. A judgment needs to be made about whether capital gains should be taxed more lightly than other forms of investment income and, if so, whether indexation is the best mechanism for that purpose. The rationale for taxing capital gains more lightly than income is discussed in the preceding chapter.

12.3 For some individual taxpayers, capital gains income is currently subject to *averaging provisions*. These provisions were intended to minimise the likelihood that the realisation of a capital gain, which may have taken many years to accrue, did not push individual taxpayers into a higher marginal tax rate in the year it was realised. Such an outcome could result in the taxpayer paying tax on capital gains at a higher marginal tax rate than would apply to them in normal circumstances. However, the current averaging provisions can produce outcomes that might be regarded as inappropriate.

12.4 The *quarantining of capital losses* so that they may only be offset against capital gains is regarded by many taxpayers as unduly harsh. It is justified as a necessary offset to the realisations basis of the CGT rather than in terms of broader tax principles.

Accounting principles

In general the Australian Accounting Standards do not distinguish between income derived in the form of capital gains and other income. In fact, several accounting standards apply a mark-to-market approach and require changing asset values to be recognised in the period in which they occur as an expense or revenue:

- AASB 1023 'Financial Reporting of General Insurance Activities'; AASB 1037 'Self-Generating and Regenerating Assets' and AASB 1038 'Life Insurance Business'.
- AASB 1030 'Application of Accounting Standards to Financial Year Accounts and Consolidated Accounts of Disclosing Entities other than Companies' also allows undertakings to which Managed Investment Schemes relate to apply a mark-to-market approach to financial assets.

Consideration is currently being given to amending AASB 1010 'Accounting for the Revaluation of Non-current Assets' to allow classes of assets to be valued on either the cost basis or fair value basis. Where the fair value basis is used it would be necessary to revalue the class upon any subsequent material change in the fair value. For the longer term, consideration is also being given to requiring the change in value to be recognised immediately as either an expense or revenue, rather than through equity.

A strategy for reform

Make the treatment of assets more uniform by removing indexation

Rationale

12.5 Australia is one of the few countries that indexes capital gains. Removing indexation would simplify the law and reduce compliance costs. Leaving aside the possibility of reducing tax rates on capital gains, it would also result in all income producing business assets being treated more uniformly by the law, thereby removing tax avoidance opportunities — such as taxpayers characterising assets as 'CGT' assets to benefit from indexation. If CGT was reformed to encourage investment by lowering CGT tax rates, there is a stronger reason to support the elimination of indexation.

12.6 Where accounting standards require assets to be accounted for using mark-to-market principles no adjustment is made for indexation. In calculating accounting profits, businesses do not index capital gains. Rather, capital gains form part of normal business profits. Removing indexation would contribute towards moving tax values closer towards commercial values.

12.7 Wasting, or depreciating, assets are depreciated on a nominal basis, that is without adjustment for inflation. If an asset is sold for an amount above its depreciated value but below its original cost the full difference is brought to tax with no allowance for inflation. If the asset is sold for more than its original cost then the excess over the original cost is reduced by indexation based on the original cost, and capital gains tax applied. Such an arrangement is both complex and not symmetrical.

12.8 Removal of indexation would enable the unification of the tax law treatment of capital gains and losses for both appreciating and depreciating assets. This would allow much simplification, clarification and shortening of the business tax law — while lessening the distortive nature of current arrangements.

12.9 Removing indexation only for assets eligible for depreciation would also provide some simplification benefits. In most cases, depreciating assets would not be expected to increase in value over their useful lives and so the question of indexation would be irrelevant. This approach at least would enable a more efficient functioning of the capital allowance regime, especially as it applies to balancing adjustments.

Transitional issues

12.10 If indexation were removed, transitional issues would be important. A possible approach would be to enable all assets to retain the indexation benefits up to the date of removal. This would imply that the assets would enter the new arrangements at their indexed cost base. Capital losses realised after the date of implementation would continue to be calculated by reference to the original cost of the asset (because they are calculated from the non-indexed cost base).

Modify the rules for CGT averaging

Rationale

12.11 Individual taxpayers are able to ‘average’ their capital gains. This feature of the law was introduced to address concerns that taxing all the gains in one year would push taxpayers into higher tax brackets in that year.

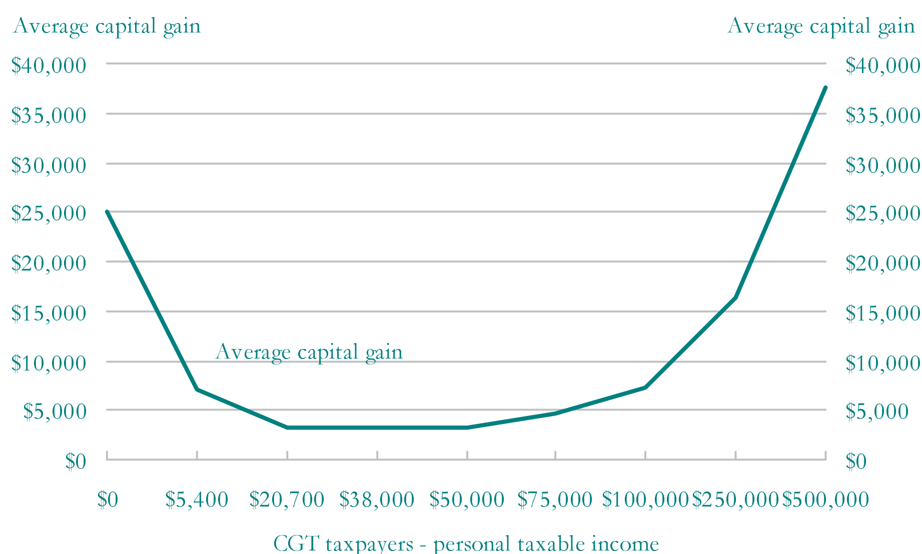
12.12 The tax payable on capital gains is calculated by dividing the gain by five to determine the rate of marginal tax that would apply to that amount when added to other income, and applying that rate of marginal tax to the total gain. Averaging can reduce the incidence of tax on relatively large gains if such gains push taxpayers into higher marginal rates. Averaging does not benefit companies.

12.13 The 'averaging' provisions can be applied even if the capital gain is realised in the same income year in which the asset was acquired.

The scope for reducing investment distortion and tax minimisation

12.14 Taxpayers who have variable income from non-capital gains can take advantage of this to realise assets selectively to reduce their effective tax burden. Averaging thus creates the potential for additional and significant taxation benefits for strategic taxpayers. The issue is particularly noticeable where taxpayers maximise the benefit of the tax-free threshold, as illustrated by Figure 12.1.

Figure 12.1: CGT averaging — how it is abused



Source: Unpublished ATO data for 1995-96.

12.15 Figure 12.1 illustrates that the average capital gain of taxpayers with zero non-capital gain income is $25,000 and these people pay no CGT. That suggests that a large number of relatively asset wealthy taxpayers are taking advantage of the benefits of averaging the tax-free threshold.

12.16 Under the existing 1/5 rule, taxpayers with zero non-capital gains income could earn up to $27,000 in real capital gains without paying any tax. This compares with an effective average tax rate of 19.3 per cent if the $27,000

were taxed under the personal income tax regime (excluding Medicare levy). Alternatively, a taxpayer could earn up to $103,500 in real capital gains and pay only 20 per cent tax compared with an effective average tax rate of 37.9 per cent under the personal income tax regime.

12.17 The benefits of the existing averaging system would generally increase under the personal income tax schedule announced in *A New Tax System*.

- Using a similar example as above, a taxpayer could earn up to $30,000 in real capital gains without paying any tax compared with an effective tax rate of 19.4 per cent if this income were taxed under the personal income tax regime. Alternatively, a taxpayer could earn up to $100,000 in real capital gains and pay only 17 per cent tax compared with an effective tax rate of 34.6 per cent if this income were taxed under the personal income tax regime.
- On the other hand the planned new tax scales will be broader — the 30 per cent rate will span incomes from $20,000 to $50,000 — and so the benefits of averaging based on the existing formula will be less for some taxpayers.

Method

12.18 If averaging is to be retained, its operation could be modified as follows:

- removing the effect of multiplying the tax free threshold — this could be done by allowing the tax free threshold only on capital and other income up to the taxpayer's tax free threshold; and
- taxing capital gains above this threshold subject to either notional two year (rather than 5 year) 'averaging' or the existing 5 year averaging to determine the marginal rate of tax on the capital gains.

12.19 Example 12.1 illustrates how such an approach might operate on the basis of two-year averaging.

Example 12.1: Possible averaging reform

Scenario 1 Assume a taxpayer has zero other income and capital gains of $25,000. As the taxpayer's other taxable income is zero the first $6,000 of capital gains under the personal income tax scale put forward in *A New Tax System* will be exempt from tax. The residual capital income of $19,000 is divided by two ($9,500) and added to the tax free threshold of $6,000 to give notional income of $15,500. As this income would be taxed at the 17 per cent tax rate, tax payable will be $3,230 (or 17 per cent of $19,000).

Scenario 2 Assume a taxpayer has $20,000 other income and real capital gains of $25,000. As the taxpayer's other taxable income is above the tax free threshold of $6,000 all capital gains income will be subject to 1/2 averaging. The capital gains income of $25,000 is divided by two to give notional capital gain income of $12,500 which is added to other taxable income of $20,000 to give notional income of $32,500. As all this notional income is above the $20,000 threshold and below the $50,000 personal income tax threshold, it would be taxed at the 30 per cent tax rate. Tax payable on the capital gain will be $7,500 (or 30 per cent of $25,000).

Scenario 3 Assume a taxpayer has $16,000 other income and real capital gains of $25,000. As the taxpayer's other taxable income is above the tax-free threshold of $6,000 all capital gains income will be subject to 1/2 averaging. The capital gains income of $25,000 is divided by two to give notional capital gain income of $12,500 which is added to other taxable income of $16,000 to give notional income of $28,500. As $4,000 of this notional income is below the $20,000 threshold it is notionally taxed at the 17 per cent rate to give notional tax of $680. As the remaining $8,500 notional capital gain is above the $20,000 threshold and below the $50,000 personal income tax threshold it would be taxed at the 30 per cent tax rate, to give notional tax of $2,550. Total tax payable on the capital gain will be the sum of notional tax of $3,230 ($680 + $2550) multiplied by 2 to give to $6,460 tax payable ($3,320 multiplied by 2).

12.20 This approach would remove the multiplication of the tax-free threshold, while retaining a feature to average capital gains above the tax-free threshold. It would retain an averaging benefit for taxpayers below the top marginal tax rate. However, compared to a 1/5 approach, the 1/2 model would more tightly constrain the amount of gains that would be taxed at the lower tax rates. Table 12.1 and Table 12.2 provide examples.

Table 12.1: Comparison of 1/2 and 1/5 year averaging where other income is zero

Method	1/2 year averaging	1/5 year averaging
Capital gain	$25,000	$25,000
Other income	$0	$0
Notional income	$15,500	$9,800
Marginal rate at which capital gain taxed	17%	17%
Tax payable	$3,230	$3,230
Effective tax rate	12.92%	12.92%
Maximum capital gain taxed @ 17%	$28,000	$70,000

Table 12.2: Comparison of 1/2 and 1/5 year averaging where other income is $20,000

Method	1/2 year averaging	1/5 year averaging
Capital gain	$25,000	$25,000
Other income	$20,000	$20,000
Notional income	$32,500	$25,000
Marginal rate at which capital gain taxed	30%	30%
Tax payable	$7,500	$7,500
Effective tax rate	30%	30%
Maximum capital gain taxed @ 30%	$60,000	$150,000

12.21 A further modification that could be made is to enable averaging to be applied only after assets have been held for one year or more. Realisation within a year can be regarded as in the nature of a windfall rather than resulting from investment, and thus there are grounds for not treating it in a concessional manner. Under the existing law the averaging benefits can be accessed immediately.

Reform the taxation treatment of capital losses

Rationale

12.22 The realisation basis of the capital gains tax regime applies to both capital gains and losses. However, capital losses are quarantined in the sense that they may be offset only against capital gains. In the absence of quarantining, taxpayers would be able to realise capital losses and offset them against ordinary income while not realising capital gains and so avoiding taxation on that income. The tax revenue would bear the cost of capital losses immediately while taxation of capital gains would be deferred indefinitely. The revenue impact of such an outcome would be very significant.

12.23 A further rationale for quarantining capital losses is the ability of taxpayers to artificially create losses. Some measures have been put in place to counter such activity and the issue is further addressed in Chapter 28 of this paper. However, removal of capital loss quarantining would increase the benefits to be gained from such activity.

12.24 On the other hand the quarantining of capital losses may be the source of a bias against risk taking, and can impact unfairly on some taxpayers who cannot use capital losses quickly, or perhaps at all.

12.25 The issue is whether the current arrangements reflect the appropriate balance between these conflicting concerns.

Method

Option 1: Allow carry-forward at an appropriate interest rate

12.26 Carry-forward of capital losses at an appropriate interest rate (perhaps the Commonwealth long-term bond rate) has been suggested as one way of easing the current arrangements. This would reduce the burden on taxpayers unable to use their capital losses quickly but would not help those who did not produce a later capital gain.

Option 2: Allow carry-back of losses to offset earlier gains

12.27 The carry-back of capital losses to offset against earlier capital gains is likely to be more complex but would also provide some relief from current arrangements.

Option 3: Remove quarantining of capital losses where gains on assets are assessed on an annual basis

12.28 Eligible assets could be those assets whose annual decline in value was estimated by various methods — for example, wasting assets with capital allowances, various rights and leases and many financial assets and liabilities. In addition, where taxpayers chose to value other assets on a mark-to-market basis, any losses could be applied against other income.

Option 4: Limit quarantining of past and future losses to shares and units in trusts

12.29 Under this option quarantining of capital losses would be restricted to shares and units in trusts assessable on a realisation basis, regardless of the type of taxpayer and circumstances for holding the asset. This option would allow other capital losses to be offset against ordinary income. The rationale for maintaining quarantining is that shares and units in trusts represent key

vehicles through which loss duplication and creation take place. They are also a major source of potential revenue volatility because of the ease with which they can be sold and the potential volatility that can occur in share markets.

12.30 All of these potential easings of current arrangements may create opportunities for exploitation by investors. However, in most cases these opportunities would be most easily exploited by the large sophisticated investor with a portfolio of assets. The scope for abuse could be reduced if the availability of any relief measures applied only to taxpayers below a certain income level, say $100,000.