e61 Submission | 19 December 2025

E61 SUBMISSION TO THE SENATE SELECT COMMITTEE ON THE OPERATION OF THE CAPITAL GAINS TAX DISCOUNT

Greg Kaplan, Matthew Maltman, and Matt Nolan

This submission offers a set of insights into the distribution of capital gains income and the general rationale for a capital gains discount. While we do not make comments or recommendations about specific asset classes, we describe the criteria that need to be considered when thinking about a tax system that treats all investments in a neutral manner.

The current capital gains discount is both inequitable and inefficient in how it incentivises investment in capital gains generating assets. However, the discount was introduced as a simple way to mitigate two justifiable concerns:

- **Taxation of inflation**: An increase in an asset price due to inflation is not real income and so should not be taxed. Although this is right in principle, it is inconsistent with how inflation is treated in the rest of the tax system. The tax system should treat inflation consistently irrespective of the income source.
- **The lumpiness of gains**: Low to middle income earners who receive an occasional capital gains would be overtaxed in a full-rate tax system, as the concentrated nature of this gain will push these individuals into a higher tax bracket for a single year. However, the appropriate discount depends on the taxpayers circumstances and the length of time the asset has been held.

The current discount fails to properly mitigate either of these concerns. It overcompensates high-income earners and undercompensates low-income earners for these issues. This is not just inequitable, but distorts the way Australian's work, save, invest, and finance their investments – generating broader productivity costs and reducing the ability for the tax system to raise necessary revenue.

There are principled ways to mitigate these issues: By providing a general allowance for the inflation component of capital income, and by spreading the capital gain over multiple tax-years (income averaging).

Along these lines, the pre-1999 treatment of capital gains was more closely aligned with tax principles – with the cost base inflated by CPI and optional income averaging. Given reductions in compliance and administration costs due to technological change since 1999, it is worth investigating whether the current discount could be replaced with a more principled approach.

The capital gains discount is inequitable and inefficient

Individuals face very different effective tax rates depending not on how much income they earn, but on how they earn it.

This difference is especially pronounced at the top of the distribution, where a substantial share of income is realised as capital gains. Among individuals at the 99th income percentile in a given year, effective tax rates vary from around 19 per cent to nearly 40 per cent (Figure 1A).[1] As shown in Figure 2, the capital gains tax discount explains nearly 80 per cent of this variation: by halving the taxable amount of nominal capital gains for assets held over a year, the tax system lowers the effective tax rate for individuals with otherwise similar economic capacity to consume.

If the tax system aims to tax a dollar of income equally regardless of how it is generated, then this differential treatment violates horizontal equity – the concept that individuals with the same ability to pay should face similar tax burdens irrespective of how their lifetime income is earned.

Unequal treatment of capital gains also distorts behaviour with real costs to productivity and efficiency. By lowering the tax rate on gains relative to other forms of saving, the discount encourages taxpayers to organise their affairs to realise income as capital gains, and may distort real investment decisions (e.g., through more lightly taxing assets that generate a larger share of income through capital gains, favouring leverage, or encouraging "lock-in" behaviour). These issues are documented in prior work, including Kaplan et al. (2025), Daley et al. (2016) and Varela et al. (2020).

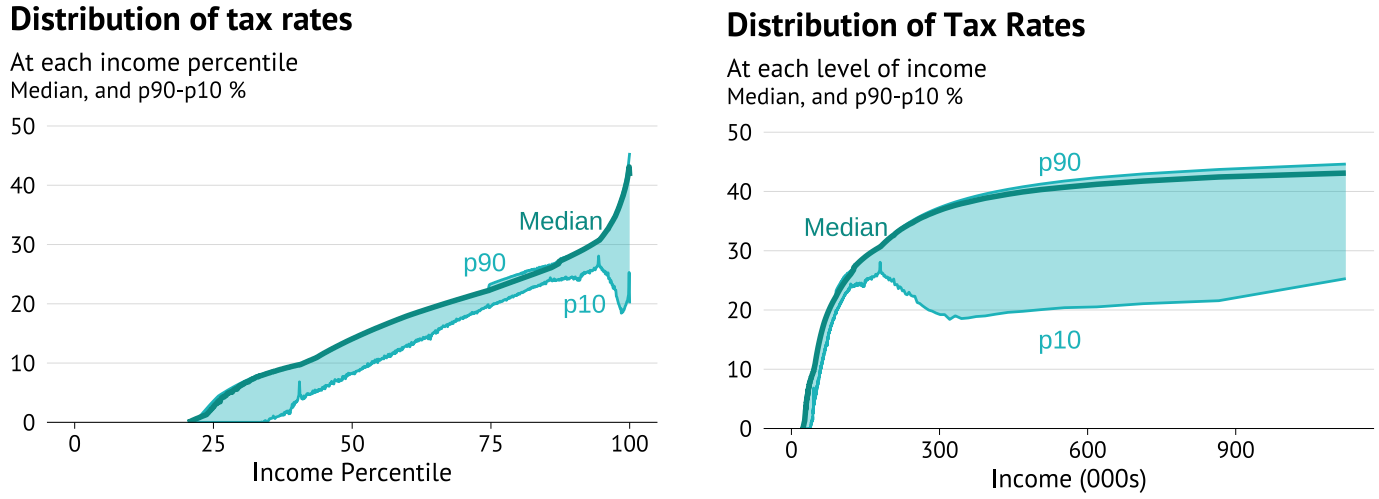
The Taxation Review Committee (1975) report (also known as the Asprey Review) puts forward two arguments in support of taxing capital gains at lower rates than other income.

- Taxing nominal gains overstates economic income because **part of the gain simply compensates for inflation**.
- **Capital gains are more volatile** than other income sources.

Both points are valid concerns about the measurement of taxable income, but are also relevant for other sources of income that are not capital gains. In this submission we discuss what these arguments mean for the design of the capital gains discount.[2] Importantly, income volatility does suggest capital gains should be taxed differently to other more regular income.

As we will outline in the submission below, the logic of the Asprey Review and the Australian Treasury (1985) tax White Paper regarding capital gains tax treatment were sound – and the pre-1999 treatment of capital gains income (with the cost base inflated by CPI and the option to apply *income averaging* to realised capital gains income) was closer to *ideal* than the Review of Business Taxation (1999) (also known as the Ralph Review) recommendation of the capital gains tax discount.

Figure 1: Effective Income Tax Rates

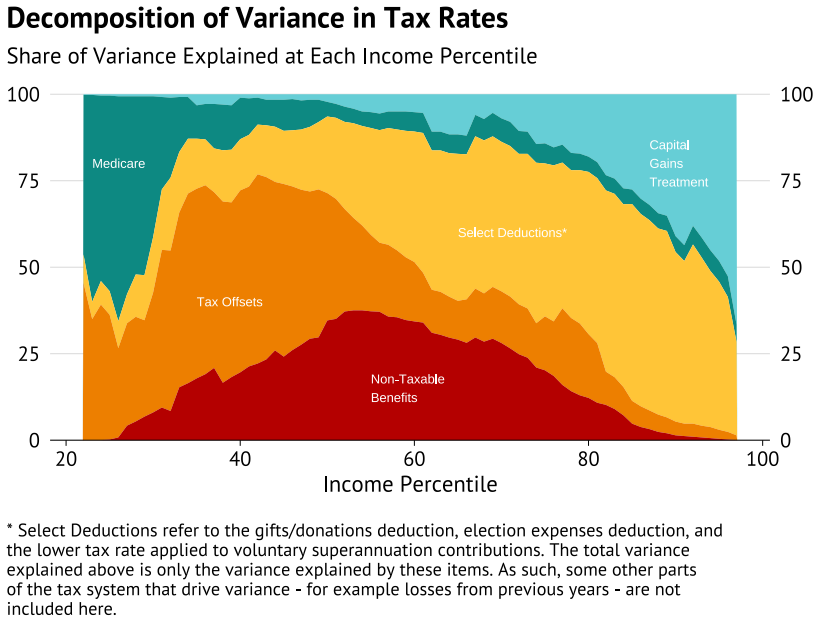


A: By income percentile

B: By income level

1 The income definition used is not taxable income, but a broader measure of gross cash income following Kaplan et al. (2025)
2 A broader argument is that capital income should be taxed more lightly than labour income to mitigate the double taxation of future consumption. This is a question about the overall structure of capital taxation, not the specific treatment of capital gains relative to other capital income.

Figure 2: What leads to the range in ETRs?



* Select Deductions refer to the gifts/donations deduction, election expenses deduction, and the lower tax rate applied to voluntary superannuation contributions. The total variance explained above is only the variance explained by these items. As such, some other parts of the tax system that drive variance - for example losses from previous years - are not included here.

This suggests a potential reform direction: **the removal of the capital gains discount and the introduction of income averaging**, where the taxpayer smooths the realised gain over their historic income. Our view is that adjustments to the discount, either by reducing the discount or adjusting relative discounts, would not deal with the core issues associated with taxing capital gains – and may have unintended negative consequences.

Inflation alone does not justify the CGT discount

Box 1: Inflation and the capital gains discount

One rationale for the capital gains discount is that it represents *an allowance for inflation*. We believe this is a poor rationale for the discount as:

- **The inflationary component of other income is taxed**: This means that, if inflation is positive, capital gains are taxed at a lower rate than other capital income.
- **As the inflationary component of interest can be deducted, a discount incentivises excessive leverage**: This means that the discount doesn't just bias investment, but also biases the way investment is financed.

Given these concerns, a principled approach would exclude the inflation component of all income from taxation – not just from capital gains.

Furthermore, a discount is an inappropriate tool for providing an allowance for inflation – both at current rates, and even if the discount was reduced. A lower discount does not solve these two issues, while the Australia's Future Tax System Review Panel (2010) recommendation to provide the discount for most capital income would mitigate the first but not the second issue.

A long-standing rationale for the capital gains discount is the concern that taxing nominal gains overstates economic income. For example, if an individual holds a $100 asset that rises to $105 over a year in which the general price level also increases by 5 per cent, their real purchasing power is unchanged. The increase in value merely compensates for inflation, rather than reflecting a real increase in an individuals ability to buy goods and services. In this narrow case, taxing the total $5 gain would over-tax true income.

Compensating taxpayers for inflation can improve the accuracy of measured income – but only if applied consistently across all forms of capital income. **Currently, Australia taxes the inflationary component of other capital income which means capital gains are being treated differently to other capital income in the presence of inflation**.

While capital gains receive a 50 per cent discount (which partially removes the inflation component of the return), nominal interest and nominal dividends remain fully taxable, even though both also embed an inflation component. Adjusting only capital gains for inflation therefore creates an asymmetry, not a principled response to inflation.

Importantly, these distortions are magnified when an individual can borrow and deduct the full nominal interest payment for their nominal income. The ability to **increase leverage** allows individuals to benefit from the asymmetric treatment of inflation as gross income and as an expense in the tax system. This is discussed in greater detail in Appendix A.1.

In terms of tax principles, the ideal would be to **only tax real capital income across all sources of capital income**. An allowance for inflation would involve indexing asset cost bases by CPI and taxing only real interest and dividend income. Symmetry would require that only real interest expenses are deductible, with the inflation component disallowed to avoid encouraging leverage.

If there are strong practical policy reasons why an allowance for inflation should not be provided, this same rationale would hold for capital gains income. In that case, it is likely to be preferable to tax all capital income on a nominal basis – and thereby not distort relative investment and financing choices – rather than give an allowance for only one form of capital income. In other words, **if for policy reasons no inflation allowance is provided to other capital income, it should not be provided to capital gains**.

But the irregularity of capital gains risks overtaxation

Box 2: Irregular income and the capital gains discount

A second argument is that capital gains income may be overtaxed as they are *irregular* – implying that a greater proportion is taxed at the top tax rate, compared to a situation where the income is earned in smaller amounts over time. This is a relevant as:

- **The tax difference can be substantial**: An individual who earned the average full-time wage in Australia would pay a tax rate of 23.8%. An individual who earned a similar amount through capital gains each ten years would pay a tax rate of 41.6%.
- **The penalty is higher for low income individuals**: Even with the current discount, someone earning less than $50,000pa already pays a higher tax rate if they earned their income through irregular gains.
- **The penalty is higher for more irregular gains**: For the average income earner, someone who realises their gain every two-years will pay a tax rate of 30%. This rises to 45% for an individual who realises every twenty years.
- **Without some form of discount, up to half of all capital gains would be overtaxed**: Although capital gains are very unequally distributed, up to half of capital gains are earned by individuals who have average income below the top tax bracket.

These facts imply that the irregularity of capital gains earnings needs to be recognised by the tax system to avoid penalising activities that generate capital gains relative to other activities. A principled solution to this is to allow individuals to spread the tax liability over the life of the asset.

If the aim of the tax system is to tax a dollar of income equivalently regardless of how it is earned, then capital gains should not receive preferential treatment. However, taxing capital gains at full marginal rates also raises legitimate equity and efficiency concerns. Realised capital gains are typically large, irregular and volatile. **As Australia applies a progressive tax scale on an annual basis, an individual who realises a large gain in a single year will face a higher marginal tax rate than another individual with identical lifetime income that is earned smoothly over time**.

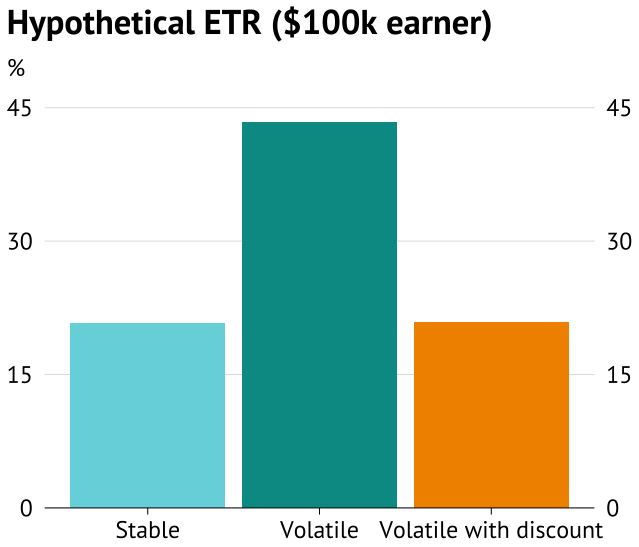
This matters because the progressive tax schedule is intended to reflect differences in ability to pay over a lifetime, not year-to-year fluctuations in the timing of income. Annualising the tax scale is an administrative simplification, but for highly uneven income streams it distorts tax burdens. Two individuals with the same lifetime income can face very different effective tax rates solely because one receives their income regularly (e.g. wages) while the other receives their income in a few large, infrequent realisations (e.g. business sales or investment gains). This is both unfair and disincentivises productive investments with lumpy returns.

To illustrate, consider two individuals who each earn $6 million over a sixty-year career. The first earns $100,000 of wages each year. The second earns no income for nine years and then realises a $1 million capital gain in year ten, repeating this cycle six times. Both households have identical lifetime income, but the volatility of the capital gain earner's income profile pushes them into higher tax brackets in the realisation years. As a result, under full rate capital gains taxation their effective tax rate over their lifetime would be 41.6 per cent – around 75 per cent higher than the 23.8 per cent lifetime effective tax rate faced by the stable wage earner.

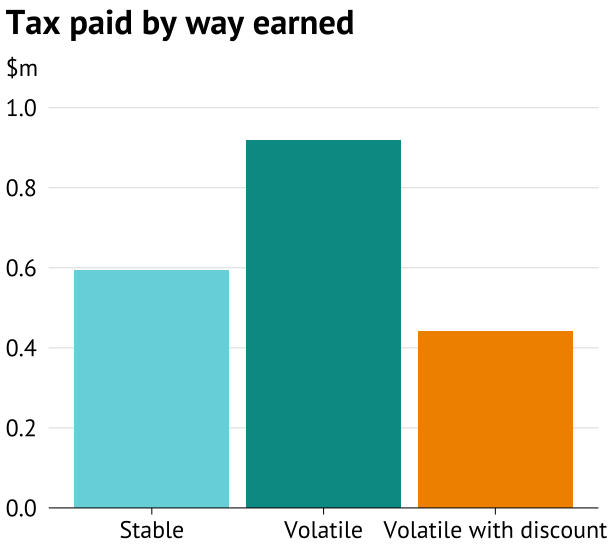
The current 50 per cent capital gains tax discount reduces this inequity by lowering the tax payable in realisation years. With the discount, the volatile capital-gains earner faces a lifetime effective tax rate of 19.7 per cent, compared with 20.8 per cent for the stable wage earner. The discount also reduces the present value of lifetime tax liabilities because tax payments are deferred until realisation. Taken together, these features slightly over compensate the inequity created by applying the progressive tax scale annually to volatile income for the average full-time wage earner.

In the absence of the discount, taxing capital gains at full marginal rates would penalise individuals with lumpy or entrepreneurial income streams relative to those with stable earnings – violating horizontal equity over the lifetime and discouraging risk-taking. **A well-designed reform would therefore take account of both the volatility of capital gains and the length of the holding period, rather than providing a uniform discount across all gains regardless of size, maturity, or the taxpayer's broader income profile**.

Figure 3: Tax rates for an "average" earner



* This is the ratio of lifetime tax paid and income received, not PV values. The earnings occur over 60 years, with the stable earner receiving this amount each year. The volatile earner receives ten times the annual amount every ten years, and nothing in other years.
Source: e61

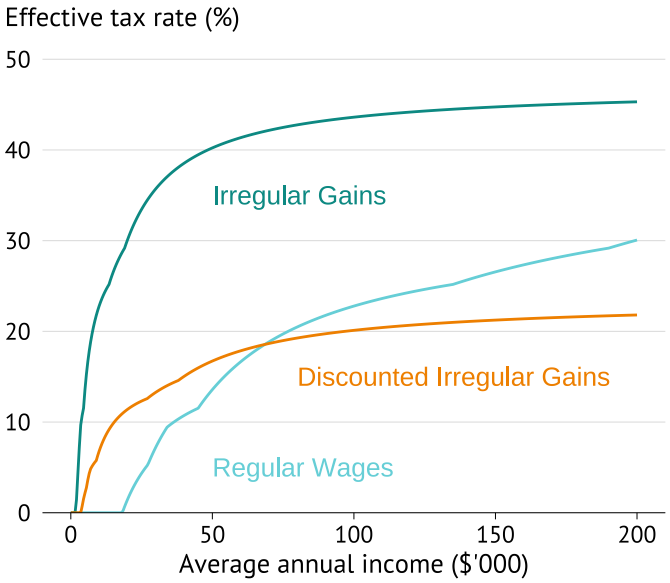


* PV over 60 years of tax payments.
** Present Value of Tax Paid (discount rate = 3%)
*** Volatile earner receives $1m every 10 years. Stable earner receives $100,000 each year.
Source: e61

The appropriate capital gains discount therefore varies with both income and the asset's holding period. Figure 4 shows that the current 50 per cent discount over-taxes gains for individuals with incomes below $50,000, relative to a comparable wage earner. The discount becomes increasingly concessional for higher-income individuals, with undertaxation widening substantially at the top of the distribution. Conversely, longer holding periods strengthen the case for some discount as shown for an individual earning $100,000 in Figure 5. Overall, this suggests that the current flat 50 per cent rate is poorly targeted to either volatility or holding period.

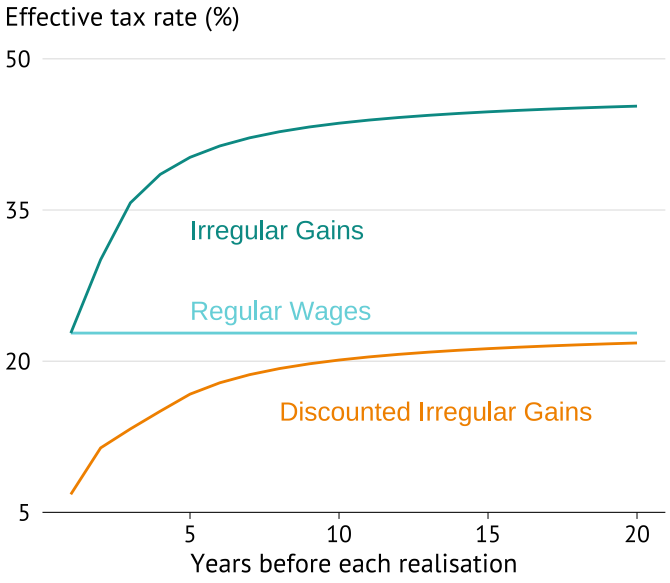
These issues are not only theoretical. Figure 6 shows actual effective tax rates in Australia over a longer horizon (2012-2022), measured as total tax paid over ten years divided by total income earned over the same period. This shows substantial dispersion in lifetime effective tax rates across income groups. For the average earner effective tax rates now vary between 4.6% and 18.8%, with a sizeable number of individuals paying both more and less than the median effective tax rate of 10.7%. This pattern reflects both the progressive tax scale and the concessional treatment of capital gains. For some high-income individuals, the capital gains discount pushes their effective tax rate materially below the statutory marginal rate, while for others the bunching of large realised gains into a single year (and other drivers of income volatility) temporarily pushes them into considerably higher brackets.

Figure 4: Overall ETR by Average Income



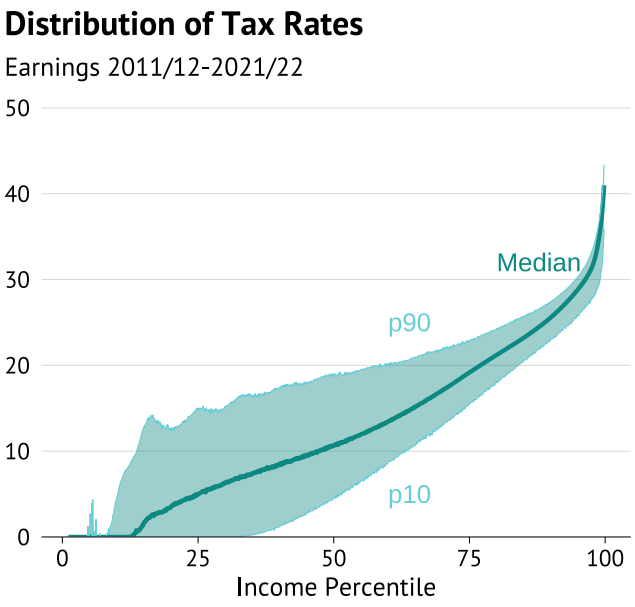
* ETR is total tax over 60 years divided by total income over 60 years.
** Capital gain is realised every 10 years. No real income growth occurs.
Source: e61

Figure 5: Overall ETR by regularity of capital gains



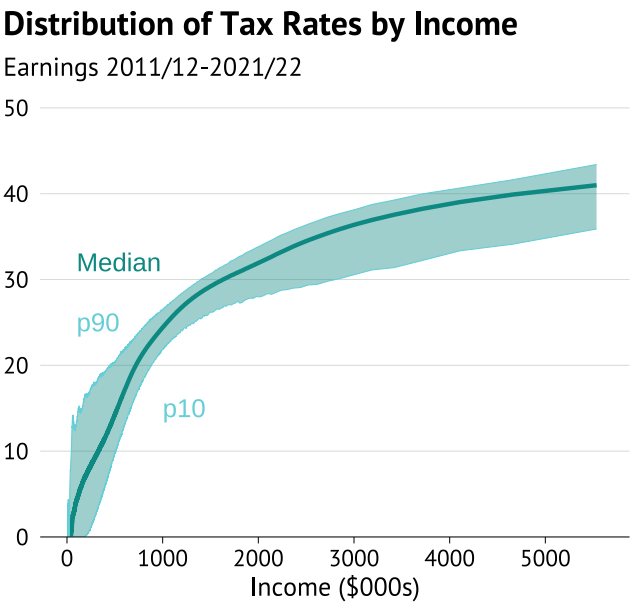
* ETR is total tax over 60 years divided by total income over 60 years.
** Average annual income is $100,000 in all cases. No real income growth occurs.
Source: e61

Figure 6: Effective Income Tax Rates



Sources: ABS; e61

A: By income percentile

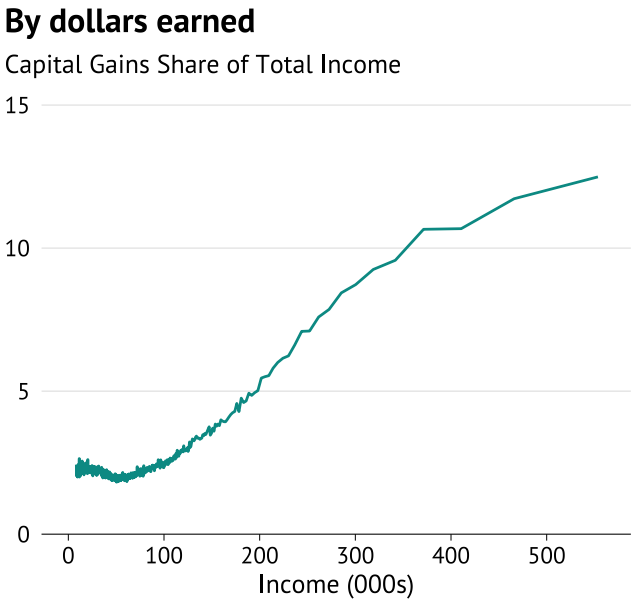


Sources: ABS; e61

B: By income level

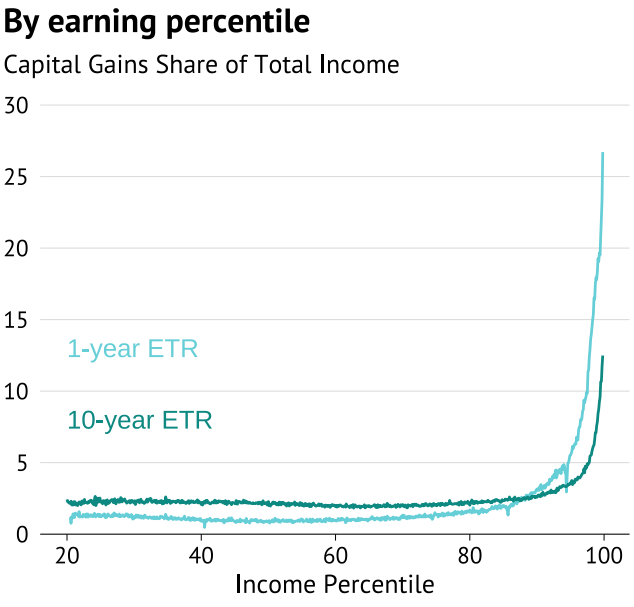
Due to top-coding in the data, these estimates likely understate the true variation at the very top of the income distribution. As a result, our estimates of capital gain earnings in the top 1-2 percentiles are conservative. However, this does show that the combination of progressive annual taxation and the capital gains tax discount creates wide dispersion in effective tax burdens measured over a decade, especially for middle income earners. Furthermore, this highlights that the lifecycle distribution of capital gains is somewhat less concentrated among high-income earners than a one-year snapshot would suggest (Figure 7B).

Figure 7: Capital gains income shares



Sources: ABS; e61

A: By average annual income over 10 years



Sources: ABS; e61

B: By 10-year income percentile

It is still the case that capital gains income is heavily earned by those at the top of the income distribution. As those from the 97th percentile and above would be in the top tax bracket persistently if their income was smoothed over 10 years, these earners (which conservatively account or 47% of capital gains) should receive roughly no discount to correct for income volatility.

However, for earners below this percentile, capital gains still reflect 2.5% of total income – and full removal of discounts would likely increase effective tax rates for this group relative to other regular sources of earnings.

Evidence from Clark (2014) shows that holding periods for different asset classes vary substantially – highlighting that individuals who intend to hold for different periods of time, or with assets that have longer payoff periods, are being taxed differentially. The authors find that in Australia realised gains on shares tended to occur after roughly four years, while gains on residential property were realised after around ten years. Such variability in holding periods means that individuals face very different capital gains tax outcomes depending on the timing and nature of their assets, even with identical lifetime incomes. A uniform discount applied to all realised gains therefore produces uneven effects across taxpayers.

Incorporating adjustments for holding periods is often ruled out due to concerns about "lock-in" effects. The lock-in effect of a realisation-based capital gains tax reflects the fact that individuals may delay selling assets to defer tax liabilities (Beer et al., 2023). While this creates a theoretical rationale for taxing capital gains at a lower rate, recent work in Aguiar et al. (2024) suggests that the distortion from the lock-in effect is less important in a system where real realised gains are taxed. In other words, although realisation timing does vary substantially across assets and individuals, the behavioural costs of a realisation-based system appear relatively small if we get the general tax treatment right, and the current discount is poorly targeted at the inequitable differences in tax rates that individuals will face depending on how long they hold the asset.

Taken together, the evidence shows that effective tax rates vary widely across individuals with similar long-run incomes, both because capital gains are taxed preferentially and because the timing of their realisation interacts with a progressive annual tax schedule. The current capital gains tax discount therefore imperfectly addresses inequities arising from volatility and timing, while simultaneously creating new inequities and distortions elsewhere in the system.

A principled solution to this would aim to allow individuals to *smooth* their tax liability over the life of the asset – treating the realised gain as if they had accrued a share of that realised gain in each of the prior years the asset was held. This form of **income averaging** is already applied to special professionals who tend to have volatile income, and was previously available as an option for capital gains earnings (prior to 1999).

What would “ideal” look like

Capital gains taxation is part of the broader income tax system. Its purpose is not to influence behaviour in one direction or another, but to raise revenue in a way that is horizontally equitable and minimises distortions to saving and investment decisions.

From first principles, an ideal system would tax capital gains on a real, accrual basis: gains would be adjusted for inflation, and the real increase in value would be attributed to the years over which it accrued.[3] This ensures that taxpayers with the same present value of lifetime income face the same present value of tax, regardless of the timing or volatility of their gains. While the Haig–Simons framework embodies this benchmark, recent work by Aguiar et al. (2024) shows that a realisation based system that taxes real gains may be closer to optimal.

Australia’s pre-1999 system moved partway toward this ideal by providing both indexation and income averaging, the latter designed to mitigate the inequities created by taxing lumpy gains under an annual progressive schedule. The Taxation Review Committee (1975) Review emphasised the importance of both features. The averaging rule employed at the time — adding 20 per cent of the gain to taxable income and multiplying the resulting tax by five — was a pragmatic simplification, assuming a five-year holding period and relatively stable income. A more accurate method would have required detailed historic tax information and asset-level records, which were difficult to obtain or process in that era.

The Review of Business Taxation (1999) Review and subsequent reforms replaced these mechanisms with the capital gains discount, motivated by concerns about complexity, tax planning through trusts, and the desire to encourage greater investment. The Henry Review later recommended a 40 per cent discount applied uniformly to all capital income, again prioritising simplicity. However, these reforms also weakened the connection between tax liabilities and true economic income, and they largely ignored the role of income volatility and heterogeneous holding periods in generating inequitable outcomes.

Modern administrative capability changes the trade-off between simplicity and accuracy. Digital record-keeping, pre-fill, and improved ATO systems mean that far more accurate asset-level information can be collected and processed at low cost. This raises the possibility of returning to a system that more closely aligns tax with economic accrual. For example, if reliable information on purchase price, holding period, cost base, and sale price could be accessed, a revised form of income averaging — allocating the gain across the years the asset was held — could substantially improve the fairness and neutrality of capital gains taxation. But implementing such a system would also require multi-year liability calculations that are unreasonable to impose directly on taxpayers without strong administrative support.

Australia’s pre-1999 experience also highlighted risks with such averaging: income averaging created opportunities for tax planning through trusts and imposed non-trivial compliance burdens. Some of these concerns have since been mitigated by changes to trust taxation and better reporting systems, but others remain relevant.[4]

Ultimately, the taxation of capital gains reflects a clear trade-off. A discount-based system offers simplicity, but at the cost of significant inequities and distortions. A system that aligns tax liabilities with real economic income offers greater fairness and efficiency, but requires more sophisticated information and administration.

The central question is whether modern technology and reporting systems now make it possible to implement a more principled approach at reasonable cost — and whether the benefits of simplicity in the current system continue to outweigh the inequities and inefficiencies documented in this submission.

3 This is also assuming other income is also taxed on a real basis.

4 Concerns about tax planning through trusts have been in part mitigated by changes to the taxation of trusts since 1999, with the penalty tax rate for minors and the need for taxpayers to report their share of trust income and pay at full marginal rates in the year. Furthermore, the character of a capital gain in a trust is of the nature of income for the beneficiaries of the trust – not a single individual. Unlike personal services income, in many circumstances the income is generated by the asset rather than the efforts of an individual, making individual level taxation potentially inappropriate if we viewed the allocation of capital gains in a similar way as gifting the underlying savings in the asset across beneficiaries. Furthermore, Minas and Freudenberg (2020) highlights that many of the concerns about trusts and compliance were overstated at the time.

References

Aguiar, M. A., Moll, B., & Scheuer, F. (2024, September). *Putting the "finance" into "public finance": A theory of capital gains taxation* (NBER Working Paper No. 32951). National Bureau of Economic Research. Cambridge, MA. https://www.nber.org/papers/w32951

Australian Treasury. (1985). *Reform of the Australian Tax System: Draft White Paper*. Australian Government Publishing Service.

Australia's Future Tax System Review Panel. (2010). Australia's future tax system: Final report [Also known as the Henry Review].

Beer, S., Griffiths, M., & Klemm, A. (2023). Tax distortions from inflation: What are they? how to deal with them? *Public Sector Economics*, *47*(3), 353–386. https://doi.org/10.3326/pse.47.3.3

Clark, J. (2014). *Capital gains tax: Historical trends and forecasting frameworks* (Economic Roundup No. Issue 2) (Accessed 2025). Australian Treasury. https://treasury.gov.au/publication/economic-roundup-issue-2-2014

Daley, J., Wood, D., & Parsonage, H. (2016). *Hot property: Negative gearing and capital gains tax reform* (Accessed 2025). Grattan Institute. Melbourne. https://grattan.edu.au/report/hot-property/

Kaplan, G., Maltman, M., & Nolan, M. (2025). Who Pays Income Tax? The Distribution of Individual Income Tax Rates in Australia. *e61 Micro Note*, *2025*(26).

Minas, J., & Freudenberg, B. (2020). Australia's 50% CGT Discount: Policy Oversight? *Australian Tax Forum*.

Review of Business Taxation. (1999). A tax system redesigned: More certain, equitable and durable [Also known as the Ralph Review].

Samuelson, P. A. (1964). Tax deductibility of economic depreciation to insure invariant valuations. *Journal of Political Economy*, *72*(6), 604–606.

Smeeding, T., & Weinberg, D. (2001). Toward a Uniform Definition of Household Income. *Review of Income and Wealth*, *47*, 1–24.

Taxation Review Committee. (1975). *Full report of the taxation review committee* (Also know as the Asprey Review). The Parliament of the Commonwealth of Australia. Canberra.

Varela, P., Breunig, R., & Sobeck, K. (2020). *The Taxation of Savings in Australia: Theory, Current Practice and Future Policy Directions* (TTPI Policy Report No. 01-2020) (Published 9 July 2020, post date 21 March 2022). Tax and Transfer Policy Institute, Australian National University. https://taxpolicy.crawford.anu.edu.au/publication/ttpi-policy-reports/17399/taxation-savings-australia-theory-current-practice-and

A.1. Inflation and Leverage

The argument for providing an allowance for inflation for capital gains becomes more complex when leverage is introduced – with the current discount incentivising excessive leverage.

Leverage influences the ex-post return associated with inflationary shocks. If an individual buys a $100 asset using $90 of debt, they sacrifice only $10 of their own funds to generate a nominal $5 gain. When the nominal interest rate equals inflation, servicing the loan exactly offsets the inflationary component of the gain, and the investor earns no real return – consistent with the unleveraged case. However, if inflation unexpectedly raises the asset price to $106 instead of $105, the real value of the debt falls, and the 6 per cent asset gain translates into a 15 per cent return on equity. This illustrates that part of the gain received by leveraged investors reflects the inflation-driven erosion of the real value of debt (a transfer) – something the tax system does not capture. Assessing historical capital gains without accounting for financing therefore mixes inflation on the asset side with inflation on the debt side, making nominal gains a poor proxy for real income.[5]

However, for productivity costs from tax policy the key issue is how these features affect investment incentives. As established in the public finance literature (e.g., Samuelson (1964)), a neutral tax system should not distort the relative attractiveness of different forms of saving. Under a fully nominal income tax – where all nominal capital income is taxed, and all nominal expenses are deductible – expected inflation is already incorporated into nominal interest rates and asset returns. In that setting, and in the absence of a capital gains tax discount or indexation, the tax system is ex-ante neutral with respect to leverage and the form in which returns are received.

Neutrality is lost only when capital gains receive preferential treatment, such as the current 50 per cent discount (or through indexation without adjusting interest deductibility to disallow inflation expenses). **The capital gains discount breaks the symmetry between the taxation of nominal gains and nominal interest, encouraging taxpayers to structure returns as capital gains and to favour debt-financed investments**.

We can show this by evaluating our example where the only nominal income received represents inflation. This is shown in Table 1.[6] In this case the capital gains discount leads to a smaller tax penalty for the taxation of inflationary gains relative to interest or dividend income (a 0.7% real loss instead of a 1.4% real loss). Due to this, individuals will favour assets that generate capital gains relative to other assets.

Income type	Gross income	Net income before tax	Taxable income	Net tax	After-tax income	Nominal ROE (equity)	Real ROE (equity)
Interest/dividend (no disc.)	$5.00	$5.00	$5.00	$1.50	$3.50	3.5%	−1.4%
Capital gain, unlev. (no disc.)	$5.00	$5.00	$5.00	$1.50	$3.50	3.5%	−1.4%
Capital gain, unlev. (50% disc.)	$5.00	$5.00	$2.50	$0.75	$4.25	4.25%	−0.7%

Table A.1: Tax treatment of nominal types of nominal capital income under different regimes with a 30% flat tax.

This incentive is strongly increased when an individual can leverage. In the scenario in Table 2, the interest rate is equal to the nominal return received from the asset (and so equal to the inflation rate). We then consider a situation where someone

5 In the illustrative examples, the asset and the loan are assumed to earn only an inflationary return, allowing a clear analysis of whether the tax system treats inflation.

6 Nominal asset returns are calculated as the change in the market value of the asset over the period. In the leveraged case, nominal income to equity equals the asset price change minus nominal interest paid on debt. Taxable income is computed by applying the capital gains discount where relevant and deducting nominal interest expenses, with tax liabilities calculated at a flat rate τ. After–tax nominal return on equity (ROE) is defined as after–tax nominal income divided by initial equity. Real ROE is then obtained by deflating the nominal ROE using the Fisher equation,

$$r^{\text{real}} = \frac{1 + r^{\text{nom}}}{1 + \pi} - 1,$$

where π denotes the inflation rate.

borrows 90% of the funds needed to purchase the asset (90% leverage). In this circumstance both the nominal interest expense and income only reflect inflation. In the absence of the capital gains discount, leverage does not change the return on equity – as both the income and expense associated with inflation are treated symmetrically by the tax system. However, once the discount is introduced the real return on equity becomes positive – with the individual earning a 5.7% real return, even though all of the gains were due to inflation.

Income type	Gross income	Net income before tax	Taxable income	Net tax	After-tax income	Nominal ROE (equity)	Real ROE (equity)
Capital gain, 9x lev. (no disc.)	$5.00	$0.50	$0.50	$0.15	$0.35	3.5%	−1.4%
Capital gain, 9x lev. (50% disc.)	$5.00	$0.50	−$2.00	−$0.60	$1.10	11.0%	5.7%

Table A.2: The effect of leverage with and without the discount.

The Australia's Future Tax System Review Panel (2010) report (often called the Henry Review) recommended a more consistent solution to the differential treatment of capital income: applying an allowance for inflation or for a normal return to all forms of capital income. Such an approach would remove inflationary distortions between asset classes. The review operationalised this with a flat 40 per cent discount for all capital income on the grounds of simplicity.

However, this would neither deal with concerns about leverage or appropriately allow for inflation given the capital gains have an implicitly longer holding period than other flow sources of capital income. **A consistent inflation adjustment applied across all capital income would achieve the intended neutrality more directly – both in terms of incentives regarding where to invest and how to finance investment**. But that is not what the current capital gains tax discount provides.

APPENDIX : ABS DATA DISCLAIMER

The results of these studies are based, in part, on data supplied to the ABS under the Taxation Administration Act 1953, A New Tax System (Australian Business Number) Act 1999, Australian Border Force Act 2015, Social Security (Administration) Act 1999, A New Tax System (Family Assistance) (Administration) Act 1999, Paid Parental Leave Act 2010 and/or the Student Assistance Act 1973. Such data may only used for the purpose of administering the Census and Statistics Act 1905 or performance of functions of the ABS as set out in section 6 of the Australian Bureau of Statistics Act 1975. No individual information collected under the Census and Statistics Act 1905 is provided back to custodians for administrative or regulatory purposes. Any discussion of data limitations or weaknesses is in the context of using the data for statistical purposes and is not related to the ability of the data to support the Australian Taxation Office, Australian Business Register, Department of Social Services and/or Department of Home Affairs' core operational requirements.

Legislative requirements to ensure privacy and secrecy of these data have been followed. For access to MADIP and/or BLADE data under Section 16A of the ABS Act 1975 or enabled by section 15 of the Census and Statistics (Information Release and Access) Determination 2018, source data are de-identified and so data about specific individuals has not been viewed in conducting this analysis. In accordance with the Census and Statistics Act 1905, results have been treated where necessary to ensure that they are not likely to enable identification of a particular person or organisation.