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EVERYONE IS DIFFERENT: THE PROBLEM WITH A FLAT CAPITAL GAINS TAX DISCOUNT

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Capital gains tax is part of Australia's *income* tax system. As laid out in the Asprey Review 50 years ago, the policy aim is to tax real capital income similarly to other income, such as wages.

To do this, it is important to adjust for inflation so that the real component of capital gain – the true rise in consumption ability – is included in the tax base. The rationale for the current 50 per cent discount is mainly to serve as a simple proxy for inflation adjustment.

The problem with the discount is that it fails to reflect heterogeneity of real returns across investments and taxpayers. This is a problem with any fixed percentage discount.

In reality, real returns are spread across a distribution. In the face of this variation, a flat discount leads to substantial under-taxation of some investments and over-taxation of others.

Using microdata on 1.5 million property investments between 2008 and 2025, we find:

- **Real gains differ significantly between taxpayers**: the average real (after inflation) return was 2.5 per cent. However the 25th percentile return was a loss of 1.6 per cent and the 75th percentile return was a 5 per cent gain.
- **This indicates under-taxation of those with high gains**: the top quartile of real gains (above 5 per cent return) would see only two thirds of their real gain taxed on average.
- **Changing the amount of the percentage discount does not fix this problem**: if the discount had instead been 33 per cent, the top quartile would have been taxed on 87 per cent of their gains (on average) with substantial over-taxation of those with low, or negative, real gains.

Much of the debate has focused on whether the current discount is the 'right' number, or whether it is too generous.

Using microdata to shed light on the *distribution* of returns shows that any fixed percentage discount generates the 'wrong' number for almost every individual taxpayer, leading to substantial under and over taxation of individual investors. The rough justice of a single discount turns out to be more rough than justice.

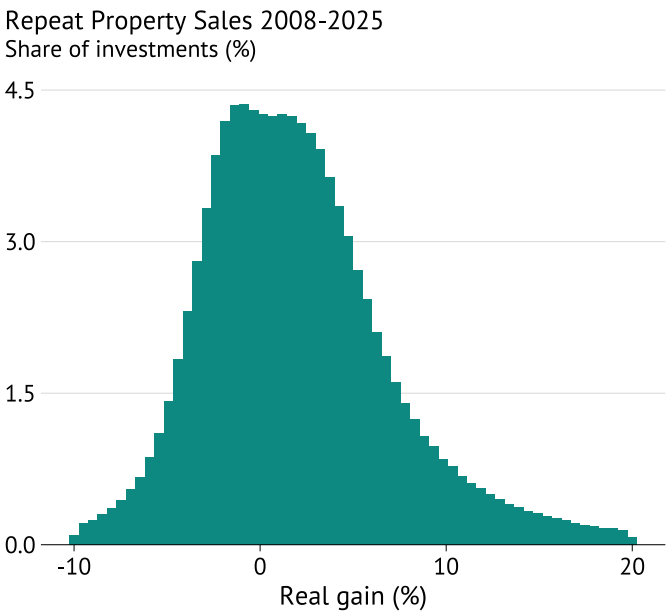
Replacing the discount with cost base adjustment for inflation would remove these inequities. Moreover, it is likely to increase government revenue given the current under-taxation of large dollar gains realised by some investors.

In this note we examine how closely taxable capital gains under the current system correspond to the real gains actually earned by property investors. If real capital gains are similar across investors, then a percentage-based discount system may decently approximate of the real income investors earn from capital gains. However, if there are significant differences across investors, then a flat discount will significantly overtax some and undertax others.

Understanding this issue is of central importance when evaluating whether Australia should continue to offer a percentage-based capital gains discount, or instead transition to an inflation-based cost-base adjustment system like the proposal in Dwyer et al. (2026). Under this type of adjustment, the cost-base for assessing the capital gain is increased by inflation over the holding period of the asset – generating taxpayer specific "discounts" that can differ based on the specific experiences of that taxpayer. The more heterogeneity there is in the real gains of individual taxpayers, the higher the efficiency and equity costs of a flat discount, making a more tailored cost-base adjustment system more attractive.

We measure the distribution of real percentage gains using PropTrack transactions data on all property investments bought after mid-2007 and sold before mid-2025, and CPI inflation data from ABS. This allows accurate measurement of the cost base and realised sale price of different assets, to compute the capital gain received by each investor. Figure 1 shows the distribution of real annualised housing capital percentage gains. Percentage gains vary substantially across properties and holding periods – a quarter of investments gained less than -1.6% and a quarter gained more than 5%. This wide variance in gains generates substantial dispersion in the difference between taxable and real gains across investors.

Figure 1: Distribution of Real Housing Gains



Sources: e61; Proptrack

How does this heterogeneity in real gains translate into differences between taxable income and real income? When an investor's taxed gain exceeds the real gain they receive, they are being overtaxed, and vice versa. We term the difference between the an investor's taxed gain and their real gain the **taxation gap**, measured in annualised percentage points. In the case where a flat discount is applied, like the current tax system, the tax gap can be measured in the following way:

$$
\begin{aligned}
\text{taxation gap} &= \text{taxable nominal percent gain} - \text{real percent gain} \\
&= (1 - \text{discount}) \times \text{nominal percent gain} - (\text{nominal percent gain} - \text{CPI inflation}) \\
&= \text{CPI inflation} - \text{discount} \times \text{nominal percent gain}
\end{aligned} \tag{1}
$$

Equation (1) demonstrates than when the discount is 50%, a nominal percentage gain less than double inflation implies overtaxation (a positive taxation gap), and a nominal percentage gain over double inflation implies undertaxation.[1]

If instead the capital gains discount was replaced with a cost-base adjustment equal to CPI inflation, the taxable nominal gain would be equal to the nominal gain minus inflation. As a result, the taxation gap would be zero for every taxpayer irrespective of their circumstances.

We can explain this with an example of how the gap between taxable and real gains varies with a fixed inflation rate of 2.5% and a holding period of just over one-year. In this example, if an asset provides a 1.5% real capital gain, the cost base of the asset (sale price + non-deducted expenses) is 4.0% higher than its purchase price (in nominal terms). If there was no discount, the full 4.0% would be taxed, which would include the 1.5% real income and the 2.5% inflation components.

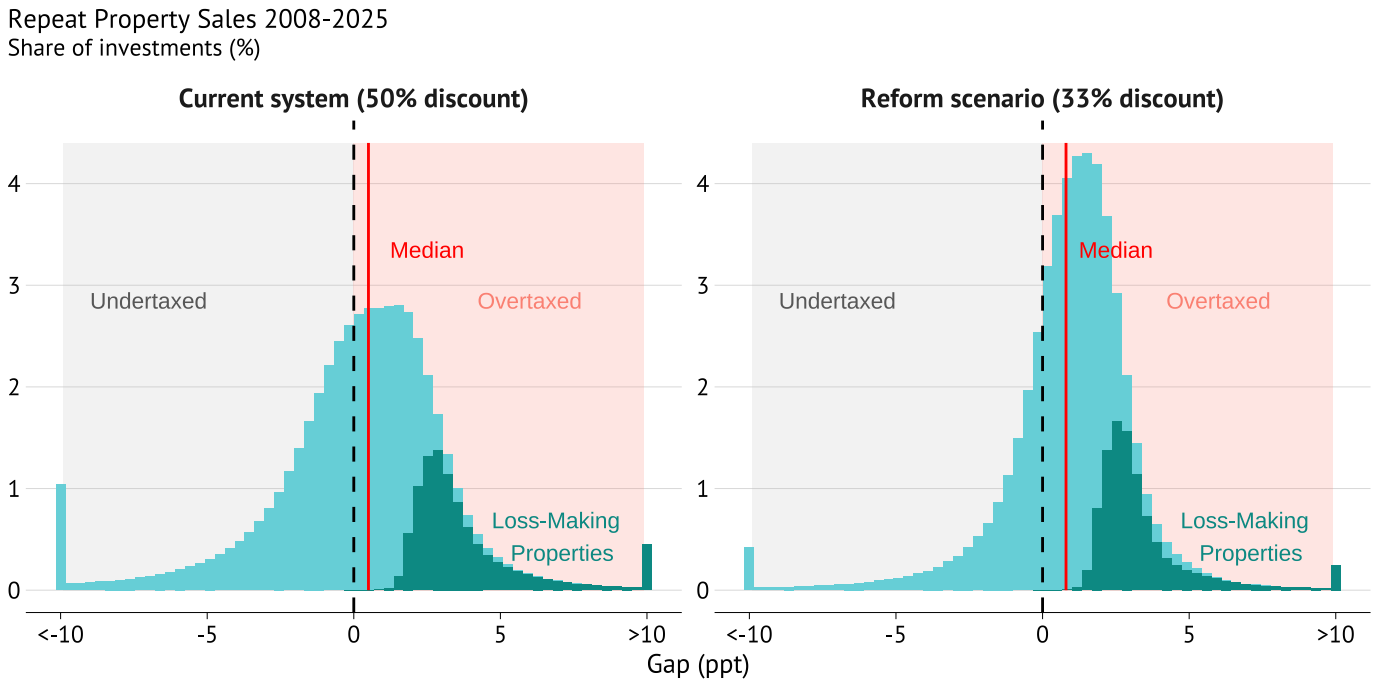
The 50% discount approximates the inflationary component of these gains as being half the total gain. In our example, a 2% gain is taxable as real income. However, the actual real gain is lower than this, so the discount causes overtaxation, or in other words, inflationary gains are still being taxed. This investor has a *positive taxation gap* under the current tax system, which implies they are paying too much tax.

However, for an investor with a real gain of 3.5%, the discount would be too generous – taxing them on only a 3% real gain. For this investor there is a *negative taxation gap* under the current tax system, which implies they are paying too little tax.

1 This is an approximation of the taxation gap for simplicity, by using the Fisher equation to approximate the appropriate adjustment for inflation. As holding periods increase this approximation becomes less precise. The actual estimates use the full cost base adjustment. It also assumes that all gains will be taxed at the same rate – if the capital gain pushed individuals into a higher tax bracket the actual discount system would reduce the tax paid by more than in this example.

Overall, how many gains are over- and under-taxed therefore depends on the distribution of asset price changes. To examine this in practice, we analyse repeat sales of residential properties between 2008 and 2025 using property transactions data.

Figure 2: Distribution of Gap Between Taxable and Real Returns



* Assuming losses are deductible
Sources: e61; Proptrack

Applying the taxation-gap definition in equation (1) to the observed distribution of housing price changes produces the distribution in the left panel of Figure A.2. A qualification is that these housing returns do not include investment costs like real-estate agent sales commissions, so slightly overstate the full capital gain. Nonetheless, the results indicate that the taxable gain often differs materially from the real gain earned by investors.

In this exercise, the 50% discount is roughly appropriate for the median investor. However, the large dispersion in real returns implies that most individuals over- and under- pay tax. Approximately 6.0% of individuals receive a real percentage gain that is more than 5 percentage points higher than their taxable percentage gain. For these individuals their real gain is at least 74% higher than the capital gain they are taxed on.

Furthermore, loss-making properties are highly penalised. Of loss making properties, half have a real loss that is over 4.5 times what the deductible nominal capital loss would be. Many of these owners would be receiving tax credits, but even if they could immediately cash these out their value is substantially smaller than the tax rate times the actual loss in economic income they have experienced.

One proposal to address concerns about equity is to reduce the discount to 33% as shown in the right panel of Figure A.2. However, reducing the discount has little effect on the variation across investors. Because real percentage gains differ widely, a fixed discount will continue to produce both over- and under-taxation depending on the relationship between inflation and the realised gain.

This means that while adjusting the discount can change the alignment between taxable and real gains for the median investor, it cannot remove the underlying dispersion.

The variation in tax base gaps also has implications for the amount of capital income captured by the tax system. When the taxable gain is smaller than the real gain, part of the real income from capital gains falls outside the tax base. Because high-return investments generate a large share of total gains, the amount of real capital income excluded from the tax base

can be substantial. As was shown in Dwyer et al. (2026), the current system leaves a meaningful portion of real capital gains income outside the tax base.

Under our sample of repeat sales we find that, in 2022, a cost-base adjustment system would have generated a tax base of $29.7B in capital gains, compared to $29.3B and $22.0B for a 33% discount and 50% respectively. This does not directly translate into revenue as we cannot observe the marginal tax rate of the individuals earning these gains. However, in conjunction with the revenue findings in Dwyer et al. (2026), this does suggest that a cost-base adjustment system would raise revenue relative to the current system by taxing individuals with high real returns on their full real income.

Australia's capital gains discount was designed as a simple way to account for inflation and the timing of gains. However, because inflation and real gains vary across assets and investors, a fixed discount very rarely aligns the tax base with real economic income. Instead, replacing the discount with a cost-base adjustment would improve equity by taxing all of, and no more than, the real income generated from capital gains.[2] Furthermore, it would likely raise more tax revenue by increasing tax payments from those who generate high real returns.

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2 An alternative approach to focusing on real income is given in the public finance literature. Here the opportunity cost of saving a dollar is defined as the *normal rate of return* which tends to be higher than inflation. Under this alternative framework the discount for the cost-base adjustment should be at a higher rate than inflation – but the same framework for interpreting relative returns discussed here still holds.

A.1. Examples of overtaxation and undertaxation

Example 1: Low real return (overtaxed)

- Nominal gain: 4%
- Inflation: 2.5%
- Real gain: 4% − 2.5% = 1.5%
- Taxable gain under the 50% discount: $0.5 \times 4\% = 2\%$

$$\text{Taxation gap} = 2\% - 1\% = +1 \text{ percentage point}$$

In this case, the taxable gain exceeds the real gain because inflation is properly accounted for in the tax base.

Example 2: High real return (undertaxed)

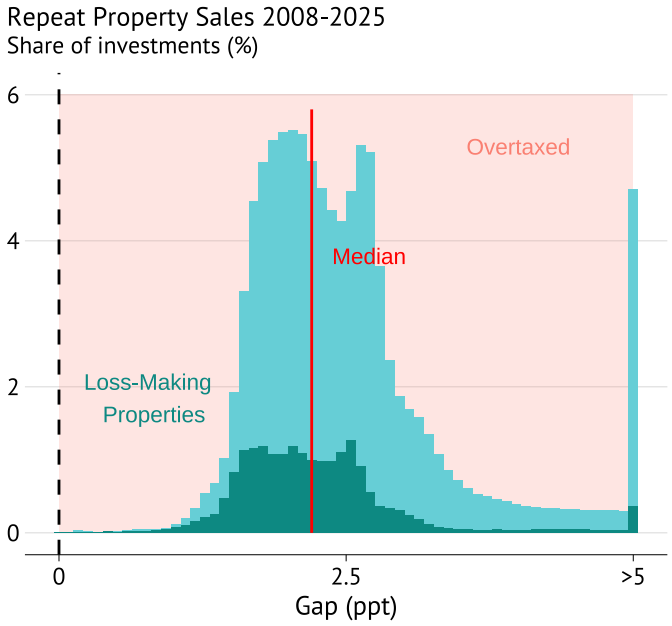
- Nominal gain: 6%
- Inflation: 2.5%
- Real gain: 6% − 2.5% = 3.5%
- Taxable gain under the 50% discount: $0.5 \times 6\% = 3\%$

$$\text{Taxation gap} = 3.5\% - 3\% = -0.5 \text{ percentage points}$$

In this case, the taxable gain is smaller than the real gain, so part of the real income from the capital gain falls outside the tax base.

A.2. Additional Charts

Figure A.1: Distribution: Gap Between Taxable and Real Gains under 0% Discount



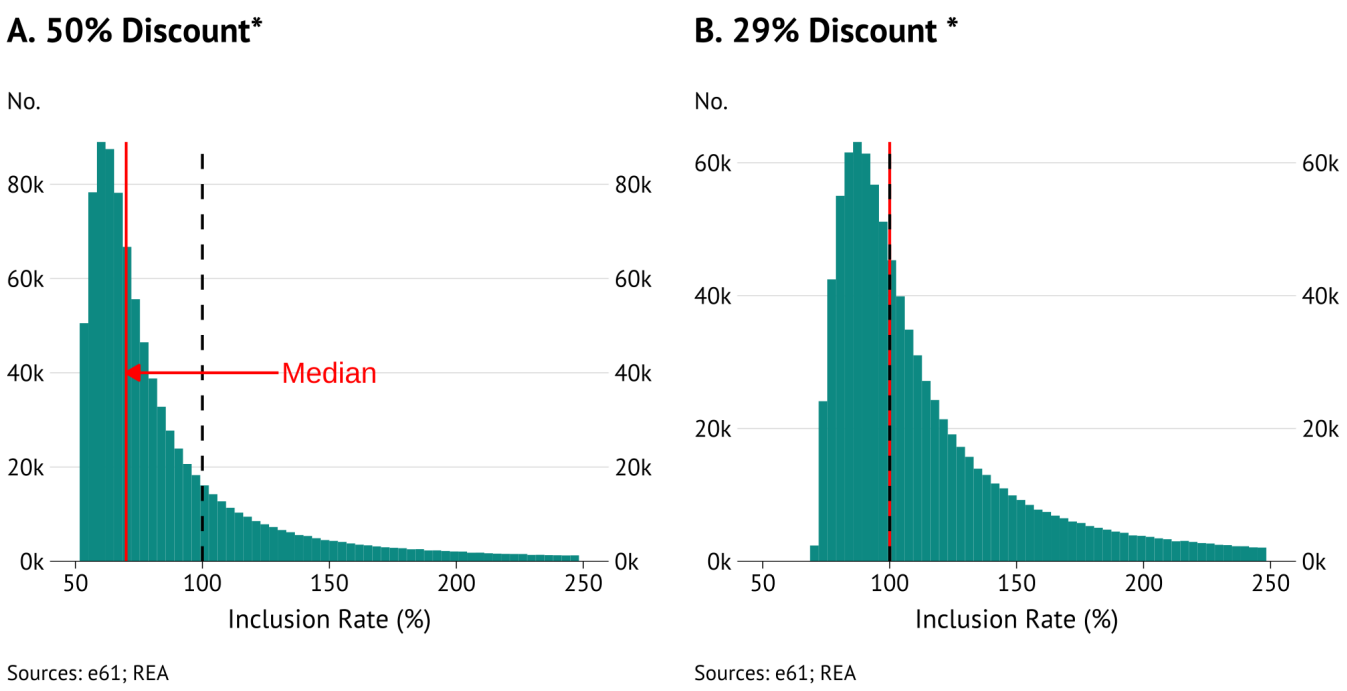
* Assuming losses are deductible
Sources: e61; Proptrack

Another way to visualise the effect of the discount is to measure an *inclusion rate*. This represents the ratio of taxable income to real income for varying taxpayers. When this is below 100, an individual is being taxed on less income than they earn, while when it is greater than 100 they are being taxed on more income.

This is shown only for individuals who have positive real returns.

Figure A.2: Inclusion rates

Non loss-making property repeat sales (2008-2025)



Sources: e61; REA

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