FORUM

INFLATION AND CAPITAL GAINS TAX

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A capital gains tax is imposed on the gains from the realization of property where such realization is not concerned with carrying out a business. The introduction of such a tax in Australia has been foreshadowed several times (the latest being in the 1974–5 budget in a form following Asprey Committee[1] recommendations). Although never carried out, a more suitable environment could see a reintroduction of the proposal.

Capital gain is made up of two components—an increase in the dollar value due to inflation, and an appreciation of the real value of the assets. In its proposed form, the capital gains tax was to be imposed on both components of the gain.

The justification for a capital gains tax is based on equity grounds. *An equitable* taxation system should tax people according to their ability to pay and the burden of taxation should fall as evenly as possible on all taxpayers. Ability to pay is related directly to economic power which can be indicated by the personal parameters of income, consumption expenditure and wealth. In Australia, the wealth base is presently covered primarily by death taxes. Wealth in the form of realized capital gains consumed during the taxpayer's lifetime is taxed less than conventional market power parameters (e.g., income). The fact that more affluent individuals generally realize more capital gains add to the inequity of a taxation system where progressiveness is a desirable characteristic.

In the rural sector, land is an important, if not the major, capital asset. It is therefore appropriate to study the effect of inflation on the changing capital values of rural holdings (and potential tax payable).

To illustrate these effects a study was made of changing land values in eleven regions of New South Wales. For each area, values[2] of land suitable for commercial production of a district enterprise (i.e., excluding rural residential type blocks) were selected. The valuations chosen reflected the largest proportional increases in land prices over the study period. This was done so the maximum real capital gains for the district were used in the analysis.

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[1] Taxation Review Committee, *Preliminary Report June*, 1974. (Australian Government Publishing Service, Canberra, 1974.)

[2] Reserve Bank of Australia, *Rural Valuation Information* (various issues).

In the calculations, the base year land price was adjusted by the consumer price index[3] to establish the expected price at the realisation date of land with an unchanged real value. Comparison between the actual present valuation and the inflated original value (i.e., constant real value) enabled the relative importance of inflationary gains in total capital gain to be determined. The results are summarized in table 1.

Where price increased in the study period, the inflationary gains ranged from urban influenced area where about 20 per cent of capital gains were due to inflation to regions where all appreciation was illusory.[4] As noted previously, under the suggested capital gains tax legislation, all gain would be taxed. It would, in fact, mean a tax on inflationary gains regardless of the magnitude of, if any, real gains experienced.

The proposed legislation also allowed for unlimited carrying forward of capital losses. This may be quite significant for farmers who sell several farms over time at different levels of profit or loss. The situation exists where absolute price is unchanged over time (e.g. Western Division, Riverina) and, in real terms, is actually declining as prices are failing to keep pace with inflation, yet losses are not credited against the owners.

A means of incorporating the effect of inflation into a taxation system is indexation.[5,6] By calculating what component of an absolute capital gain is real and taxing only that part, the burden of the gains tax in relation to real wealth would be spread more evenly. It would eliminate the present position which varies from landholders who are paying mainly (or solely) for inflation to those whose land value has increased sufficiently to make inflation a minor component of total capital gains.

A tax on wealth appears to improve the equity of the taxation system. If a capital gains tax is more appropriate than the existing death taxes the implementing legislation should, in this inflationary climate, include indexation as a fundamental provision. This is important for the rural sector where a significant proportion of land appreciation appears due to inflation and where property sales are often used to finance later rural ventures. Indexation of any proposed capital gains tax is necessary to maintain the intended equity of the burden of taxation.

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[3] The consumer price index was used as an estimate of the general level of inflation.

[4] Further investigation indicated that the results may be sensitive to the period studied. However, in all cases it was found that at least 20 per cent of capital gains could be attributed to inflationary pressures. Considering that this was the minimum impact of inflation on capital appreciation it can be expected that illusory gains will form a significant part of any capital gains.

[5] Ideally, for equity reasons, all parts of the taxation system should be tied to inflation.

[6] The problems associated with indexation, as noted by the Taxation Review Committee, include administrative complexity and treatment of the situation where monetary debts are incurred to purchase the original capital accumulating asset. It is felt these difficulties, although significant, do not invalidate the overall justification for indexation of capital gains taxation.

TABLE 1

Changing District Land Values

Region	Farm type	Years studied	Maximum proportional price increase	Per cent absolute capital gain due to inflation[1]
Southern Tablelands ..	Grazing (sheep/cattle) ..	1960–72 ..	\$25 to \$70/acre ..	22
Sydney (Bowral)	Grazing (sheep/cattle) ..	1960–70 ..	\$110 to \$225/arable acre	29
Mitchell ..	Grazing (sheep/cattle) ..	1962/3–71 ..	\$42 to \$72/grazing acre ..	43
North Coast ..	Dairy	1961–71 ..	\$85 to \$140/acre ..	46
New England ..	Grazing (sheep/cattle) ..	1960–69 ..	\$34 to \$70/cleared acre ..	21
South Coast ..	Grazing/dairying	1961–72 ..	\$30 to \$75/grazing acre ..	27
Monaro ..	Grazing (sheep/cattle) ..	1960–72 ..	\$20 to \$30/grazing acre ..	80
Macquarie ..	Mixed (wheat/sheep/cattle)	1963/4–72 ..	\$40 to \$50/cleared acre ..	100
Namoi	Mixed (cereal/coarse grain/ sheep/cattle).	1962–72 ..	\$34 to \$47/cleared acre ..	100
Western ..	Grazing (sheep)	1964/5–69/70..	No price increase ..	Real capital loss
Riverina	Grazing (sheep)	1963/4–71/72..	No price increase ..	Real capital loss

Sources: Reserve Bank of Australia, *Rural Valuation Information.*
Australian Bureau of Statistics.

[1] Calculations: Per cent absolute capital gain due to inflation $= \dfrac{Pb_{(r)} - Pb}{Pr - Pb} \times 100$

where

Pb = base year valuation

$Pb_{(r)}$ = price at realization date with unchanged real value (i.e. $Pb \times$ C.P.I.)

Pr = actual realization value