CAPITAL GAIN TAX FOR REAL PROPERTY: WHY IS THIS TAX SYSTEM SO COMPLICATED?

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ABSTRACT

In Australia, a Capital Gain calculation is applicable on the disposal of real property. However, there are some specific exemptions, such as the family principle place of residence, and rollover provisions. The Australian Taxation Office has identified taxpayers' compliance with capital gain obligations as a significant risk. For instance, taxpayers incorrectly categorising or calculating their capital gain. Interestingly, prior to 1999 only one method for calculating capital gain existed, and yet now with our "simplified tax system" there are 3 different methods available. Since 1999 with the release of the Ralph Report and more recently the Henry Tax Review (2010), various recommendations were proposed to improve this section of the taxation system. It is argued that the complexity of the capital gain calculations, particularly with the infrequency of transactions which occur over long periods of time, and compounded with complex transactions, has contributed to the taxpayers incorrectly reporting their Capital Gain information.

Keywords: Capital Gain, Real Property, Taxation

INTRODUCTION

The real property industry in Australia is one that intersects the boundaries of many aspects of taxation. Ownership of real property, for example, may be as simple and straight-forward as ownership of the family home or an investment property by individuals, or as complex as ownership of investment properties through companies, trusts and unit funds. Thus ownership of real property may involve taxation matters relevant to capital gains tax, small business taxation, company taxation and goods and services tax. Additionally real property may be income producing – therefore, taxation laws relating to the deductibility of items and negative gearing of real property are pertinent.

A fundamental reform of Australia's taxation system occurred with the release of the Ralph Report (A Review of Business Taxation, Aa Tax System Redesigned, 1999 chaired by John Ralph AO) in 1999 which resulted in a major overhaul of many taxation areas, and the introduction of the Goods and Services Tax in July 2000. Whilst the GST aimed to reduce the tax burden on ordinary incomes (eg. salary and wage earners to receive a reduction in their marginal tax rates), this was offset by transferring some of the tax burden over to consumption (e.g. supply of goods and services) and to remove wholesale tax and some state and territory taxes. The GST, is a broad based tax of 10% which applies to goods and services supplied and expended, including real property transactions such as commercial and residential property. However, the introduction of GST was not the only major change to Australia's taxation system. The method of calculating Capital Gain liability changed from one method of application to a choice of three methods, depending on various conditions being met.

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This current complexity associated with capital gain is highlighted with many property investors unclear as to which method of calculation to adopt, the relevant dates used to determine ownership and disposal of the real property, and the application of exemptions to capital gain liability. For example, the principle place of residence is exempt from capital gain, however, if the property during its lifetime was used for income producing purposes, then there is a proportional liability, and this is also dependant on the date the current owner acquired the real property asset. These significant differences have added to the complexity for many individual taxpayers

Therefore, this research paper examines the application of capital gain for real property transactions. The paper aims to identify processes which would assist the taxpayer to comply with correct disclosure of capital gain transactions. Whilst it is argued that the complexity of the capital gain calculation has contributed to this incorrect reporting, there is also the consideration that the acquisition and disposal of real property, for many individual investors, occurs infrequently and generally over long periods of time.

The first part of the paper discusses the literature for taxation levied on real property, issues associated by taxpayers for not disclosing all their capital gain income, and the relationship with property prices. The research continues with a discussion on the current methods of capital gain liability, however, this is limited to individual taxpayers, as it is beyond the scope of this paper to include other entities such as a company, trusts and superannuation funds. The paper concludes with recommendations to assist the taxpayer in meeting their reporting obligations to the Australian Taxation Office.

LITERATURE REVIEW

The introduction of Capital Gains was proposed during the 1985 Tax Summit by the Labour Government and formally legislated during that year. (CCH 2011). Researchers have argued that property taxes, such as Capital Gains Tax, and Goods and Services Tax is a regressive tax because lower income earners are adversely affected since a higher proportion of their income is consumed with tax, in comparison to those who are earning a higher income.

Interestingly, Blount (2000), sought to discover patterns for public opinion on a range of tax issues in Australia, and concluded that taxpayers preferred "higher indirect taxes" with an "aversion to visible taxes". Later, Feld and Schneider (2003) argued that the more complex the taxation system is for a country, then there is a greater chance that the perceptions of the consumer will be towards their true tax burden and therefore their tax resistance is lessened. A comparison of property taxes for residential development in Sydney and Taipei concluded that taxes affect the price of Sydney properties but not so for Tapei (Chan, Chen 2011). Their study included commonwealth and state taxes and was restricted to the Sydney residential market only.

American studies over the years have attempted to link property taxes with property prices. For example, Bradbury, Mayer, Case (2000) examined property values assuming there was a property tax limit implemented together with a limit on the nominal annual growth of the property in Massachusetts, and surplus taxes could be invested into school funding. Their research concluded that purchasers were prepared to pay the increased taxes if the funds were syphoned towards school spending. This end result saw a negative outlook for housing demand and home prices. This theory is further supported by Ladd and Bradbury (1998) who discusses the importance of local property taxes in the US cities which rely on this income to finance their local public expenditure. Their research queried any valid links between local property taxes and the city's property tax base, and argued that income taxes could also affect property prices. Their theory was further supported with an empirical study undertaken which concluded that property values were affected by taxes against property.

The hypothesis that property prices are affected by property taxes was further reiterated by Madsen (2009) who also investigated the effects of taxes on house prices and concluded that in America, taxes were considered to be "highly influential" in determining the housing price stock. The American research has focused on the residential sector and little reference is provided for their commercial sector, which might indicate that in economic terms, the residential sector dominates over the commercial sector. This theory is

supported with research undertaken in Australia using input and output tables and concluded that the residential sector played a more important role in the Australian economy (Song, Liu 2005).

Another approach for investigating the property tax and property price relationship was undertaken by Krmenec (1991), where he applied a simple accounting framework to determine patterns of property sales and property tax receipts. He separated the real growth (e.g. policy induced amount), from the apparent growth (e.g. induced by the consumer), and concluded that sales tax revenue would grow faster than property tax revenue because this was linked back to consumer spending which attracted higher sales tax in regions where it was highly populated with residential properties.

As early as 1956, a model developed by Tiebout hypothesised that consumers would select and shop for properties according to the location of and ease of the "production and consumption of local public goods" e.g. schools, shops etc with little regard to the price for these services. The Tiebout Hypothese was eventually extended in 1974 by Hamilton who linked the behaviour of economic agents to the local governments. Hamilton's argument was based on the premise that if consumers did "shop" for local public services then it stood to reason that local government elections would be unanimous if all of the residents were satisfied with the public service demands available to be utilised. In contrast, Henry (1974) acknowledged that many research studies indicated that property tax was highly regressive but he refuted this theory stating that many of the assumptions in the studies were not supported by "plausible theory". He argued that property tax was "far less regressive than the most widely quoted evidence suggests" but conceded that lack of data would hinder the hypothesis that property tax is progressive.

Other studies in America capitalised the tax with property but there was little evidence provided to indicate whether rentals increased or decreased and if subsequently property values would decrease if rents were lowered. Oates (1969) concluded that "local property values bear a significant relationship to the effective tax rates". These empirical studies provided a basis for further research which was continued by Pollakowski (1969) who undertook an analysis on local public spending and the consequential impacts on the residential property values. His model quantified the demand and supply variable in the housing market and also paid specific attention to the fiscal variable, and concluded that there was a highly significant negative impact between property taxes and property values. In contrast Edel and Sclar (1974) considered the supply adjustment with local public goods such as schooling in relation to house values, local taxes and service delivery in the Boston area, and acknowledged difficulty with the viability of Oates model, when using the capitalisation approach. To support this theory further, Krantz, Weaver, Alter (1982) researched the capitalisation model using the effective tax rates as a measure of the tax burden for property owners and concluded that 60% of the tax changes were incorporated into the value of the residential properties sampled. Historically research has highlighted the role of taxes in the models developed for house prices confirming their major influence for user costs of capital. (Kearl 1979, Dougherty and Order 1982, and Poterba 1984). Therefore, there are various studies both nationally and internationally which recognise this link between property taxation and property prices.

Another different approach to investigate the relationship between property tax and property price was undertaken by Berry (1997) who examined the differences between state tax capacity and tax effort. He defined the "tax capacity" as the "capability of a governmental entity to finance its public services" and "tax effort" as the "extent to which a government utilizes its tax capacity". He concluded that there were a number of different ways to measure this requirement and not necessarily a function of error and researchers. This approach acknowledges the correctness of research relating to the Tiebout Hypothese and provides answers for the disparity within the conclusions from various researchers. It is argued that depending on the government's budget and public spending priorities, a link with property tax and property price is maintained

It is usual to assume that real estate is illiquid, and buildings will decline in value with land increasing in value. In other words, buildings reduce in market value (Weber 2002). Depreciation is recognised for both capital equipment and the building improvements as this is a function of the buildings economic life. Rental income will diminish over time and therefore the values will decline as the building nears towards obsolescence, however it can be argued than an "older building's structural components and configurations may meet the expectations and needs of tenants" (Weber 2002).

Whilst the research discussed relates primarily to residential properties, Anderson (1993) investigated the property tax treatment for agricultural land owners by using the "use-value" method of assessment. This is where the property is valued on the presumed use for the purposes of taxation. The "use-value" method ignores considerations such as "other potential" use of the property and assumes continuation in its present use. The findings included impact and timing issues for land development and property prices. Continuing with non residential research the impact of e-commerce on commercial and retail sales and rentals was investigated. Baen (2000), considered the theory that if retail sales were more off-site and purchased via e-commerce, then eventually retail shopping centres would need to rethink through their rental approach within the shopping mall and make recommendations to counter act the possibility of long term value implications if anchor tenants had less people passing through their shops which eventually would lead to a negative impact on the small retail outlets. The relationship between e-commerce and property taxation is to demonstrate the "uncertainty" of outside influences which can impact on property prices.

The changes in 1999, for capital gain calculations in Australia, was part of the governments tax reform strategy; whilst admittedly this also included a future economic bonus for the Commonwealth. However, the international research literature presented in this paper, investigates the link with property taxes, property prices and consumer benefits and is mostly based on state taxes for these countries. In contrast, Australia's Commonwealth taxation system for Capital Gain calculations is national, and therefore there are no variances to discuss. The next section of the paper outlines the research method adopted for this paper.

RESEARCH METHODOLOGY AND LIMITATIONS

With the documented increases in non disclosure of capital gain, it is questioned whether the current taxation system is too complex; and if these circumstances provide a discord with the expectancy that the taxpayer will provide accurate information. Capital gain calculations are prevalent throughout many developed countries, however in recent years there has been a demand for a simplified approach to determine the capital gain liability when disposing of capital gain classified assets, including real property.

Therefore this research will review existing data relating to capital gain compliance via published results of on line surveys completed by individuals and tax agents. For this purpose a review undertaken by Chant Link and Associates, (CLA) in 2009 forms the primary basis of the qualitative and quantitative data in this paper. CLA included investments in shares, managed funds/unit trusts or collectables, superannuation trusts and family trusts, and a variety of business structures. Their total sample was 1010 individuals. In addition there were 154 tax agents sampled, which provided a broad spectrum of work undertaken for taxation.

Furthermore, statistical analysis obtained from the Australian Taxation Office (ATO) between the financial years 2010 to 2013 inclusive is utilised. The limitation to the research is the unavailability of data for the financial year ended 30th June 2014, which is due to the timing of the completion of this paper, and data for the 2014 financial year has not yet been published. Generally, data for each income year includes data processed up to 31 October of the following year. For example, data for the 2012-2013 income year includes data processed up to 31 October 2014.

Additionally, it is beyond the scope of this research to include all classes of assets subject to capital gain calculations, however where appropriate comparative discussions are provided; and primarily to directly link data to the CLA research, individual taxpayers are analysed rather than companies, trusts and superannuation funds. The next section of the paper commences with an overview of the current capital gain regime in Australia, followed by the data analysis and a discussion of the issues prevalent.

DISCUSSION AND ANALYSIS

In 1999, the Ralph Report recommended changes to the then current capital gain tax system, which resulted in an introduction of three different methods for capital gain calculations; an interesting complexity is prior to this date, only one method existed, and the purpose of the Ralph Report recommendations was aimed at simplifying the Australian taxation system. Similarly in 2010 the Henry Tax Review attempted to improve the regime, however, up to this current year of 2015 the rules in place are identical to those recommendations implemented during 1999.

In this regard an overview of the three current methods of calculating capital gain is provided below, followed by the research analysis and discussion. It is important to mention that capital gain applies to real property such as houses, flats, units, shops, factories, office space and other commercial property; and in addition includes other classes of assets such as shares, trusts, managed funds and other collectables. The three methods for calculating capital gain are

a) Frozen Indexation Method

This method is only applicable if the asset was acquired prior to 20th September 1985. The cost base is indexed to allow for inflation, however this indexation is only allowed up to the quarter ended September 1985, and any growth due to inflation after this date cannot be indexed. The capital gain is included in the taxpayers' current income year that the capital gain event occurred, and the tax owed on the gain will be at the taxpayers' marginal tax rate.

b) Discount Method

This method is available for any capital gain asset which has been purchased and disposed of, after being held for more than 12 months. The capital gain profit is discounted at 50%. Therefore the taxpayer will pay their marginal tax rate on the balance of the 50% capital gain.

c) Other Method

If the capital gain asset is disposed of within 12 months of acquisition, the taxpayer will pay their marginal tax rate on the entire capital gain for the asset.

To calculate the capital gain for these three methods, the cost base for the asset is subtracted from the capital proceeds. If the capital proceeds are higher than the cost base, the result will be a capital gain. Likewise if the reduced cost base exceeds the capital proceeds, then the difference is a capital loss.

The cost base and the reduced cost base will include items such as the money paid to acquire the capital gain asset, fees to a surveyor, valuer, auctioneer, accountant, broker, consultant and legal fees; stamp duty, and capital expenditure to increase the value of the capital gain asset. In summary these three methods above, provide a brief overview of the capital gain regime. The next section provides information from the ATO relating to capital gain from the years 2010 to 2013 inclusive.

Australian Taxation Office Statistics

The ATO publishes statistical information relating to various classes of tax law such as capital gain tax, fringe benefit tax, superannuation and various entity structures. The information correlated in the tables below, represents data from individual tax years summarised according to the various classifications discussed in the research for capital gain. In addition where entity quantities are used, this has been rounded to the nearest five and therefore, the totals may slightly differ from the sum of components, due to this rounding.

Table one below identifies individual taxpayers and their relative capital gain information. The first line represents the salary and wages declared by the individuals and the next line is the sum of the capital gain profit declared. Note: the data for net capital gains is irrespective whether or not salary and wages were declared. The data for net capital gains is an extraction from individual tax returns, and does not include other type of entities.

TABLE 1: INDIVIDUALS SELECTED INCOME ITEMS

	2010-2011 Numbers	2010 – 2011 $m	2011-2012 Numbers	2011-2012 $m	2012-2013 Numbers	2012-2013 $m
Salary and Wages	9,932,610	499,336	10,144,475	535,574	10,167,005	563,690
Net Capital Gains	557,015	11,619	424,320	9,188	505,750	9,874

Source: Australian Taxation Office Extracted from Table 9: Individuals selected income items
https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-statistics/Taxation-statistics-2012-13/?anchor=Individualstables#Individualstables

Therefore, for the tax years 2011, 2012, and 2013, 5.60%, 4.18% and 4.97% individual taxpayers respectively declared salary and wages plus a net capital gain on their tax return. This interpretation could be viewed as the approximate percentage of investors who disposed of a capital gain event in the relevant tax years. These individuals with employment income might be running their own small company and are therefore employed by their own company and would most likely use the services of a tax agent; and a proportion of taxpayers would be employed with an unrelated entity and could possible lodge their own tax returns. However this statistical data is unavailable and therefore difficult to assume the correct percentage split. The important point associated with this consideration relates to the CLA survey discussed later in this paper, however as a quick over-view negative feedback from individuals highlights difficulty in understanding the complexity of the current capital gain regime. Also, because the taxation system is self-assessment, there is an obligation for the government to provide to the consumer relevant details and examples on the interpretation of the current tax law. This includes access to information which is up to date and relevant. Therefore, if non-disclosure or errors for capital gain occur it would be assumed that the use of a tax agent would minimise this occurrence and so taxpayers preparing and lodging their own tax returns would be at a higher risk for non compliance.

The table below (table 2) provides figures from the financial years 2011 to 2013 inclusive, for individual taxpayers who declared a capital gain event on their income tax return. The ATO estimates the amount of tax paid on the net capital gain using the average tax rate approach. This average approach is necessary, since the data is extracted from assessable income and taxed at the marginal tax rate for the individual taxpayers.

TABLE 2: ESTIMATED TAX ON NET CAPITAL GAINS FOR INDIVIDUALS BY TAXABLE STATUS

	2010-2011 Numbers	2010 – 2011 Net Capital Gain $m	2010-2011 Capital Gain Tax $m	2011-2012 Numbers	2011-2012 Net Capital Gain $m	2011-2012 Capital Gain Tax $m	2012-2013 Numbers	2012-2013 Net Capital Gain $	2012-2013 Capital Gain Tax $m
Taxable	441,390	11,052	3,646	339,920	8,665	2,842	389,415	9,327	3,127
Non-taxable	115,625	567	0	84,400	523	0	116,335	547	0
Total	**557,015**	**11,619**	**3,646**	**424,320**	**9,188**	**2842**	**505,750**	**9,874**	**3,127**

Source: Australian Taxation Office Extracted from Table 27 and Table 30: https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-statistics/Taxation-statistics-2012-13/?anchor=Capitalgainstaxtables#Capitalgainstaxtables

Interestingly, when comparing the subsequent financial tax years against the 2011 year, there has been a decline in capital gain tax revenue at 22.05% and 14.22% for 2012 and 2013 tax years respectively. In part this can be explained due to the global financial crisis which has impacted on the economic downturn for the country. If the data is linked back to Table 1, 2013 indicates more individual taxpayers had an occurrence for a capital gain event which could indicate the struggle associated with maintaining an investment property, particularly with the 2013 increase of non-taxable taxpayers declaring their capital gain event.

The final data extracted from the ATO, relates to the break-up of the capital gain assets into the classification of shares, real estate and other assets, for individual taxpayers. This analysis is represented below in table three, where the tax year 2012-2013 identifies 40.91% of capital gain related to real estate transactions and 28.13% attributed to shares.

**TABLE 3: SOURCE OF CURRENT YEAR CAPITAL GAINS FOR INDIVIDUALS,
BY TAXABLE STATUS, 2012-13 INCOME YEAR**

	Shares $m	Real Estate $m	Other assets $m	Total $m
Taxable	6,129	8,468	6,882	21,479
Non-taxable	484	1,147	394	2,025
Total	**6,613**	**9,615**	**7,276**	**23,505**

Source: Australian Taxation Office Extracted from Table 27 and Table 30: https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-statistics/Taxation-statistics-2012-13/?anchor=Capitalgainstaxtables#Capitalgainstaxtables

The significance of this data is associated with the nature of real estate transactions which occur infrequently for many individual taxpayers. This is due in part to the large amount of money required for the long term investment, and the associated complexity with owning, managing and selling real estate. In comparison, with share transactions, smaller amounts of money can be used for investment and there is more ease associated with the acquisition and disposable of this class of asset. Therefore, there is a high proportion of individual taxpayers who are subject to a capital gain liability, but might not necessarily have frequent interaction with this type of income. Again, this raises issues of compliance and resources available for individual taxpayers, which is discussed in the next section relating to the findings in the Chant Link and Associations research.

Chant Link and Associates

The survey data extracted from the 2009 research summarised the following interesting points relating to individuals and micro businesses, capital gain events during the last three years:

1. 13% had experienced only a capital gain
2. 9% had experienced only a capital loss
3. 11% had experienced a capital gain and a capital loss
4. 14% did not have a capital event in the last three years but expected a capital gain event during the next three years.
5. 52% did not have a capital gain event in the last three years and did not expect a capital gain event during the next three years.

Therefore, to focus on the last item, at least half of the taxpayers surveyed would not be involved in a capital gain event for a span of six years. This consideration is crucial to the understanding of non-compliance reporting for capital gain events. The infrequency of requiring this tax knowledge can lead to genuine mistakes occurring and omissions of relevant information. Further research data revealed a good understanding that real estate and shares attracted capital gain events, however there was very little awareness of other classes of assets which were also subjected to this regime. Approximately one third of individual taxpayers understood the capital gain calculations with the majority stating that capital gain was too complex. In this regard the question arises whether or not the non-compliance is linked back to these issues raised in the survey? And as noted earlier in the paper the data from the ATO identifies, for individual taxpayers, over 40% of capital gain transactions related to real property; and as discussed in this paper, traditionally a real estate asset involves large sums of money for investment and is usually associated as a long term investment vehicle.

Apart from surveying individual taxpayers, tax agents were also sampled, and the results showed at least 50% dealt with capital gain events "on average at least a few times a month" with only 12% stating their capital gain dealings were less than every few months. Therefore, we can surmise that tax agents have considerable frequency using capital gain calculations, however the lag appears to relate to individual taxpayers who have infrequent occurrences of capital gain events. However in this regard, 86% of individual taxpayers had stated that their source of information for capital gain events was from their accountant/tax agent, and 67% also used the Australian Tax Office web site. There is obviously a broken link in the resource chain for reporting capital gain events and this can perhaps indicate a deliberate omission of information by the taxpayer coupled with/and/or incorrect advice provided by the accounting profession.

The research undertaken by CLA also provided for the opportunity to submit open ended comments about capital gains. A high proportion of comments included feedback that capital gain was too complex and best left to the accounting profession; the capital gain tax is an unfair regime for investors; lack of equity and incentive to take a risk for the investment of your funds when so much tax was taken away; and so on. In summary the attitudes and behaviour of individual taxpayers slants towards minimising their tax liability, and perhaps not in the most transparent approaches. This notion could possibly provide the government with an incentive to simplify the capital gain regime, both from the calculation view point and equity for the investment arena. In the next section of the paper the conclusions and findings are summarised.

CONCLUSION

It is obviously a rare occurrence for a tax system to provide transparency and an easy approach to applied taxation principles. This stems from the situation that no two cases are alike and therefore very difficult to provide model rules in a "one size fits all" approach. At best the taxation system will provide a transparent approach for varying conditions that are considered the norm. It is also important to mention that the ATO does provide individual private tax rulings when requested by the taxpayer. Therefore is the individual taxpayer justified in blaming the current capital gain regime as too complex?; and using this complexity as the excuse for non compliance?

As evidenced earlier in this paper, approximately 52% of individual taxpayers will not have a capital gain event for at least a six year span; and the majority of individual taxpayers with a capital gain event will use the services of the accounting profession. Therefore, it is difficult to ascertain the extent of the complexity influence, and to determine a direct correlation with complexity and non compliance. However considering the negative qualitative responses from individual taxpayers, a simplified tax regime would provide an incentive for individuals to minimise their tax obligations, whether intentionally legal or not. In conclusion a less complex capital gain regime would provide an opportunity to enhance the correct recording of all transactions.

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