The Review Secretariat,

Submission re Taxation of Capital Gains and Losses

Under the current law capital gains realised on the sale of capital assets must be added to the assessible income of the entity or individual and taxed as income in the year they are made, albeit at a concessional rate for individuals and superannuation funds but not for companies.

Contrast this with the treatment of losses incurred on the sale of capital assets. These losses can only be claimed against realised capital gains profits. If no capital gains have been realised, or gains of insufficient magnitude, the incurred capital losses cannot be claimed and must be carried forward indefinitely in the hope that at some stage the entity or individual will be fortunate enough to make a sufficiently large capital profit.

Let me give two examples of how the current law can work to plunder the taxpayer's assets:

1. A company buys $2million worth of shares and also real estate for $2million. A couple of years later the shares are worth $3million and the real estate is virtually unsaleable but maybe worth $1million. If the company sells the shares and cannot sell the real estate or doesnt want to at the depressed price, it will make a capital gain of $1million on the shares and have to pay tax on that profit ie it must pay say $300,000 cash as tax whilst the overall value of its assets has not increased. After paying the tax its net assets will have decreased by $300,000 even though the value of its gross assets, before the sale, had not changed.

If, after another year or two the company manages to sell the real estate for $1million it now has a $1million capital loss which it cannot claim as a tax deduction. If the company is earning interest on the $2.7 million cash it holds after the sale of the shares (sale price of $3million less tax of $300,000) it has to pay tax on that interest but cannot deduct the capital loss from its taxable income.

The company is now back owning nothing and has $3.7 million cash left from its original $4million investment. If it had borrowed 50% of the $4million invested it would be left with $1.7 million from an initial $2 million.

2. It is quite common for special purpose companies to be set up to buy real estate such as a shopping centre. The company will pay income tax on its net rental income and if it sells the property at a loss after some years it will not be able to claim a deduction for the loss even against the net income in the year of sale. If it then invests the sale proceeds and earns income, it will be paying income tax on the full amount of those earnings whilst its capital loss will be sitting there for years, unable to be claimed unless it somehow makes a capital profit.

There are many other situations I could quote which would have similar disastrous results for the taxpayer. With the drop in property values the scenario is quite common. I suggest it will also be widespread where entities or individuals have made good profits on shares during the bull market, have paid capital gains taxes on these profits, and now they will no doubt have lost money in the current bear market. Having paid tax on their previous profits they will now be stuck with significant losses which they cannot claim. The net result may be that they have suffered a serious diminution in the value of their assets but have managed to contribute significant tax to the Government whilst experiencing this net diminution of assets.

When I raised this issue with the Treasurer some years ago I received a reply from an officer in his Department saying :

" The reason capital losses can only be used to offset capital gains is because of the unique characteristics of capital gains and losses compared with other forms of taxable income. Unlike other forms of income, the taxpayer has discretion as to when he or she can realise a capital loss or gain. If capital losses were able to offset other income then there would be incentives for taxpayers to time the realisation of their losses for tax minimisation purposes. This goes against a fundamental principal of taxation policy, namely that taxation should aim to be neutral in its effects on economic behaviour."

To me that is nonsense. If a taxpayer is going to time his sales to minimise his tax he is more likely to do it under the current system as he knows he will not be able to claim a loss for years, if ever, if he gets his timing wrong now. If capital losses were claimable against income, albeit at only the concessional tax rate, there would be less incentive to try to time sales because the taxpayer would know that any loss could be claimed in the year it was incurred.

I submit that the current law is unjust and unfair. If it is good enough to treat capital gains as income why is it not good enough to treat capital losses (discounted by 50% in the case of individuals) as deductible against income.

Yours faithfully,

George Chapman AO