1. Capital gains taxes—a comparative survey

Michael Littlewood

I. HISTORY

In order to explain the current state of some of the world's capital gains taxes, it is necessary to say something about their history, and in order to do that, it is necessary to begin by canvassing briefly the history of the taxation of other forms of income—that is to say, of income taxation generally. Of the countries discussed in this book, the first to introduce a modern income tax was the UK. That happened in 1799—the government's aim being to raise funds to go towards financing the war against Napoleon. The statute then enacted is generally referred to as either the Income Tax Act 1799 or Pitt's Act, after William Pitt the Younger, who was the British Prime Minister at the time.[1]

Pitt's Act was inadequate in various respects. In 1803 it was repealed and replaced by the Income Tax Act 1803, also referred to as Addington's Act (after Henry Addington, the First Viscount Sidmouth, who had succeeded Pitt as Prime Minister in 1801). Addington's Act was more successful than Pitt's and it remained in force until Napoleon was defeated in 1815, at which point it was repealed. Thereafter there was no income tax in the UK until 1842, when Addington's system was revived by Robert Peel's administration to finance cuts in import tariffs. The Income Tax Act 1842 mostly replicated Addington's Act verbatim. These statutes—the British Income Tax Acts of 1799, 1803 and 1842—were all

[1] On the history of the British income tax see, in particular, Basil Sabine, *A History of Income Tax* (George Allen & Unwin 1966); Martin Daunton, *Trusting Leviathan: The Politics of Taxation in Britain 1799–1914* (Cambridge University Press 2001); Martin Daunton, *Just Taxes: The Politics of Taxation in Britain 1914–1979* (Cambridge University Press 2002). See also Peter Harris, *Income Tax in Common Law Jurisdictions: From the Origins to 1820* (Cambridge University Press 2006).

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based on the distinction between income (which was taxable) and capital gains (which were not).[2]

The Act of 1842 was supposed to be a temporary measure but the tax it imposed remains in force today. The legislation has been amended so often and so extensively that it now bears hardly any resemblance to its original form, but the distinction between income and capital gains remains fundamental. In particular, capital gains are generally not subject to income tax. For that reason, capital receipts were generally not taxable at all in the UK until the capital gains tax was introduced, which happened in 1965.[3]

Developments in some ex-British colonies—notably Canada, Australia and South Africa—followed what had happened in the UK. That is to say, income taxes based on the British model were introduced: they distinguished between income (which was taxable) and capital gains (which were not). Consequently, capital gains were generally not taxable in those countries until legislation was introduced for that purpose. That happened in Canada in 1972,[4] in Australia in 1985,[5] and in South Africa in 2001.[6] Some other ex-British colonies have still not introduced capital gains taxes. An example is Hong Kong, where a system of income tax was introduced in 1940 but capital gains remain non-taxable.[7] A curious hybrid case is New Zealand, where there is no tax on capital gains as such, but the definition of 'income' has been progressively extended so as to cover various classes of capital gains.[8]

Among English-speaking nations, the great exception is the US. The US introduced income tax in 1913 and capital gains were taxable from the outset.[9] In the beginning, no distinction was drawn between capital gains and other sorts of income. Consequently, capital gains were taxed at the same rates as applied to other forms of income.[10] Doubts arose,

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[2] See the works referred to at n 1.

[3] See Chapter 11 of this book (the UK). The accounts of the capital gains taxes given in this chapter are generally based on those presented in the other chapters of this book.

[4] *Income Tax Act*, SC 1970-71-72 (Canada), c 63, s 1.

[5] *Income Tax Assessment Act 1936* (Cth) pt IIIA.

[6] Income Tax Act, 58 of 1962 (South Africa), sch 8.

[7] See, now, Inland Revenue Ordinance Cap 112 (Hong Kong), as amended; Peter Willoughby and Andrew Halkyard, *Encyclopaedia of Hong Kong Taxation* (looseleaf, Butterworths 1993).

[8] See, now, Income Tax Act 2007 (New Zealand), subpt CB.

[9] Revenue Act of 1913 (US).

[10] Taxation of capital gains was confirmed by the Supreme Court: *Merchants' Loan & Trust Co v Smietanka* 255 US 509 (1921); *Eldorado Coal &*

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however, as to whether it was appropriate to tax capital gains in the same way as other forms of income and in 1921 the system was changed so that capital gains were taxed at a lower rate than other income.[11] It is widely thought that capital gains should be taxed at the same rate as other income, because to tax them at a lower rate is to invite taxpayers to adopt arrangements designed to convert income (taxable at a higher rate) into capital gains (taxable at a lower rate). If this view is accepted, the change effected in the US in 1921 was a mistake.

In any event, the US, having commenced taxing capital gains in 1913, has continued to tax them ever since. Thus the US has just over a century's experience in taxing capital gains—significantly longer than any of the other countries discussed in this book. Since 1921 the US has generally taxed capital gains realized by individuals at lower rates than were applicable to other income. The exception was the period 1986–90, during which capital gains were taxed at the same rates as applied to other income.[12] Corporations, however, are taxed on their capital gains at the same rate as applies to other income—currently 35 per cent.[13] US law also provides for short-term capital gains (gains realized on the disposal of assets held for less than 12 months) to be taxed at the same rates as apply to ordinary income.[14]

The British capital gains tax was introduced in 1965 by the Labour government that had taken office in 1964 (headed by Harold Wilson).[15] The aims were to redress the perceived inequity of taxing other income whilst not taxing capital gains and also to protect the tax base—that is, to prevent taxpayers from escaping liability by adopting arrangements designed to convert taxable income into non-taxable capital gains.[16] Throughout its history, the British capital gains tax has been charged at significantly lower rates than the income tax (for both natural persons and corporations).[17]

Mining Co v Mager 255 US 522 (1921); *Goodrich v Edwards* 255 US 527 (1921); *Walsh v Brewster* 255 US 536 (1921).

11 Revenue Act of 1921 (US).

12 See Chapter 12 of this book (the US).

13 Internal Revenue Code, 26 USC § 11 (1986).

14 Internal Revenue Code, 26 USC § 1222(1)–(4) (1986).

15 Michelle Clement, 'Harold Wilson' <www.gov.uk> accessed 22 March 2017.

16 Home Office, *Report of the Royal Commission on Taxation of Profits and Income* (Cmd 9474, 1955) paras 94–108.

17 See 'Income Tax rates and Personal Allowances', 'Capital Gains Tax' and 'Corporation Tax rates and reliefs' (2016) <www.gov.uk> accessed 22 March 2017.

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Next in line was Canada, where a tax on capital gains was introduced in 1972.[18] The principal aims were, again, to make the tax system more equitable and to protect the tax base.[19] Canada had had a federal income tax since 1916 but, as in the UK, it originally exempted capital gains.[20] Since its inception, the Canadian capital gains tax has been charged, in effect, at lower rates than those applicable to other forms of income—that being achieved by treating only 50 per cent of a taxpayer's capital gains as income (and not taxing the other 50 per cent).[21]

The evolution of the Australian tax system followed a similar pattern. Income taxes were introduced in several of Britain's Australian colonies in the late nineteenth century and a federal income tax was introduced in 1915.[22] Like the British and Canadian income taxes, however, the Australian taxes (both colonial and federal) did not extend to capital gains. But as in the US, the UK and Canada, the case for taxing capital gains eventually prevailed (propelled by notions of both equity and efficiency) and a capital gains tax was introduced in 1985.[23] As in the UK and Canada, however, the Australian capital gains tax has always been less burdensome than the income tax. Initially that was achieved by indexing for inflation.[24] In 1999, however, indexing was abandoned and other concessions were substituted.[25] Most importantly, capital gains realized by natural persons on property held for 12 months or more are generally taxed at only half the rate applicable to other income (as in Canada).[26] There is also a concessionary rate for small business entities.[27]

Similarly, an income tax was introduced in South Africa in 1914.[28] In accordance with the norm set by the UK, it exempted capital gains. A

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[18] *Income Tax Act*, SC 1970-71-72 (Canada), c 63, s 1.

[19] See Chapter 5 of this book (Canada).

[20] Richard Krever, 'The Origin of Federal Income Taxation in Canada' (1981) 3 Canadian Taxation 170.

[21] EJ Benson (Minister of Finance), *Summary of 1971 Tax Reform Legislation* (Queen's Printer 1971) 30–33.

[22] *Income Tax Assessment Act 1915* (Cth) s 10. See also Sam Reinhardt and Lee Steel, 'A Brief History of Australia's Tax System' (22nd APEC Finance Ministers' Technical Working Group Meeting, Khanh Hoa, June 2006) <www.archive.treasury.gov.au> accessed 22 March 2017.

[23] See Chapter 4 of this book (Australia).

[24] ibid part II B (4).

[25] *Income Tax Assessment Act 1997* (Cth) s 115-25(3)(a).

[26] ibid s 115-100.

[27] ibid div 152.

[28] Income Tax Act, 28 of 1914 (South Africa).

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capital gains tax was eventually introduced (for more or less the same reasons as had been found compelling elsewhere) in 2001.[29] As in the countries already discussed, South Africa taxes capital gains less heavily than other forms of income.[30]

New Zealand's experience has been somewhat different. An income tax was introduced in New Zealand in the late nineteenth century and in accordance with the British precedent it exempted capital gains.[31] Unlike the UK, Canada, Australia and South Africa, however, New Zealand has still not introduced a capital gains tax. Consequently, capital gains are generally not taxable in New Zealand.[32] However, that general rule is subject to a series of large exceptions: the definition of income has been extended so as to cover various classes of capital gains. In particular, medium-term and even long-term capital gains made on the disposal of land and securities are in some circumstances treated as income and taxable accordingly.[33] Consequently, if a capital gain is taxable at all in New Zealand, it is taxable at the same rate or rates as apply to ordinary income (whereas, as indicated above, the US, the UK, Canada, Australia and South Africa all tax capital gains at lower rates than ordinary income).

India's experience has been exceptional: a capital gains tax was introduced in 1947—about the same time as India won its independence from the UK, and 18 years before the UK introduced a capital gains tax.[34] The tax introduced in 1947 was abolished only two years later,[35] but it was reintroduced in 1956[36] and has remained in force since then.[37] Initially, India taxed capital gains at lower rates than ordinary income, without distinguishing between short-term and long-term gains.[38] Such a distinction was, however, introduced in 1962. Short-term capital gains (gains made on assets held for less than 12 months) were taxed at the average rate applicable to the taxpayer's other income; long-term gains

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29 Income Tax Act, 58 of 1962 (South Africa), sch 8.

30 South African Revenue Service, 'Tax Rates' <www.sars.gov.za/Tax-Rates/Pages/default.aspx> accessed 22 March 2017.

31 Luke Facer, 'The Introduction of Income Tax in New Zealand' (2006) 12 Auckland U L Rev 44.

32 See generally James Coleman and others, *New Zealand Taxation* (Thomson Reuters 2016).

33 Income Tax Act 2007 (New Zealand), subpt CB.

34 Income-tax Act, 1922 (India), as amended with effect from 1947 to 1949.

35 Income-tax Act, 1922 (India), as amended with effect from 1949.

36 Finance (No 3) Act, 1956 (India).

37 See, now, s 45, Income-tax Act, 1961 (India).

38 Income-tax Act, 1922 (India).

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were taxed at a flat rate of 25 per cent or the rate applicable to short-term gains, whichever was less.[39] Since then, various changes have been made as to how the line is drawn between short-term and long-term gains, with different rules for different asset classes.[40]

As one might expect, China's tax treatment of capital gains is both radically different and instructive. The modern Chinese income tax was introduced relatively recently with reforms in 1994. It comprises the Individual Income Tax Law 1980[41] (which imposes tax on the incomes of individuals) and the Enterprise Income Tax Law 2007 (which imposes tax on the incomes of corporations and other entities).[42] Neither of these statutes distinguishes between capital gains and ordinary income; consequently capital gains are generally thought of as a form of income and taxable accordingly. That is, capital gains are generally taxable at the same rates as ordinary income.[43]

II. YIELD

In all of the countries examined in this book, the taxation of capital gains has made only a relatively modest contribution to government revenues—typically around 1 per cent of total revenues.[44] Or, at least, the *direct* contribution of capital gains taxes to revenues has been relatively modest.

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[39] James Cutt, *Taxation and Economic Development in India* (Vikas Publications 1969) 113.

[40] See, for example, Finance Act, 1987 (India); Jaswant Singh, 'Union Budget 2003–2004: Budget Speech' (Ministry of Finance) <http://indiabudget.nic.in/ub2003-04/bs/speecha.htm> accessed 22 March 2017; Department of Revenue, 'Direct Taxes Code' (Ministry of Finance, 2009) ch X.

[41] Individual Income Tax Law of the People's Republic of China (promulgated by National People's Congress Standing Committee, 10 September 1980, effective 10 September 1980) [Individual Income Tax Law 1980].

[42] Law of the People's Republic of China on Enterprise Income Tax (promulgated by National People's Congress, 16 March 2007, effective 1 January 2008) [Enterprise Income Tax Law 2007]; Regulations of the People's Republic of China on the Implementation of the Enterprise Income Tax Law (promulgated by State Council, 28 November 2007, effective 1 January 2008) [Implementing Regulations of the Enterprise Income Tax Law 2007].

[43] Individual Income Tax Law 1980 and Enterprise Income Tax Law 2007 (China).

[44] For example: 0.8 per cent of GDP in Australia in 2013–14, 1.67 per cent of taxable income in Canada in 2011, 1.62 per cent of GDP in the US in 2009, 0.88 per cent of revenue in South Africa in 2012–13, and 0.66 per cent of revenue in the UK in 2011.

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It is also possible, however, that these capital gains taxes have made a substantial *indirect* contribution to revenues by protecting the income tax base—that is, by deterring taxpayers from adopting arrangements designed to convert taxable income into non-taxable capital gains. This is, however, very difficult to measure. It is notable, though, that most countries have taxed capital gains at a significantly lower rate than ordinary income (with a small number of exceptions—China, the Netherlands and, in some circumstances, New Zealand). If capital gains were taxed at the same rates as apply to ordinary income, the yield might be greater and the tax would more effectively protect the income tax base. It is worth noting, too, that whilst capital gains taxes generally contribute little to a government's overall finances, the burden is generally heavily concentrated on the affluent. For example, capital gains have recently constituted less than 2 per cent of total income in Canada, but 8 per cent of the income of high-income taxpayers.[45] The capital gains tax thus contributes significantly to the progressivity and vertical equity of the tax system.

III. A SEPARATE TAX OR PART OF THE INCOME TAX?

In most countries, the capital gains tax is part of the income tax. That is the case in the US, Australia, Canada, South Africa, India and the Netherlands. In these countries, capital gains are subject to income tax, although the rules according to which liability is calculated are not the same. Similarly in China, capital gains are typically subject to income tax; and in New Zealand, capital gains are either subject to income tax or not taxable at all. In the UK, in contrast, the capital gains tax is a separate tax.[46] Clearly, then, either approach is feasible.

One reason for incorporating the capital gains tax in the income tax is simply that there are obvious similarities between taxing ordinary income and taxing capital gains. In particular, an income tax and a capital gains tax are both, generally speaking, taxes on realized increases in net wealth (and sometimes on unrealized increases in net wealth). Moreover, even if the income tax and the capital gains tax are separate taxes, it is obviously necessary for there to be some degree of coordination between them. In particular, it is generally necessary for any realized gain to be classified

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[45] See Chapter 5 of this book (Canada).

[46] Taxation of Chargeable Gains Act 1992 (UK).

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as either ordinary income or a capital gain but not both. On the other hand, even if the capital gains tax is part of the income tax rather than a stand-alone tax, the rules for calculating liability are generally very different. That is the case in, for example, the US,[47] Australia[48] and Canada.[49]

Whether the capital gains tax is a part of the income tax or a separate tax is largely a matter of form rather than substance. Ultimately, therefore, it may make little difference whether the capital gains tax is a separate tax or part of the income tax. Even so, it would seem preferable for the capital gains tax to be incorporated in the income tax rather than for it to stand alone as a separate tax. One reason for this is that the similarities between a tax on income and a tax on capital gains are greater than the differences. In particular, capital gains and ordinary income are conceptually very similar (so similar that the difficulty of distinguishing between them is notorious) and there seems to be no advantage in having two separate taxes.

Another reason for having a single tax rather than two separate taxes is that it is widely agreed that, in principle, it would be desirable for the tax treatment of capital gains to be as close as possible to the tax treatment of ordinary income. In most countries (for example, the US, Australia, Canada and South Africa), the differences between the tax treatment of ordinary income and the tax treatment of capital gains are largely a result of political compromise rather than principled choice. If the capital gains tax is a part of the income tax, that might make it easier to bring the treatment of capital gains into closer alignment with the treatment of ordinary income. It is perhaps relevant to note in this connection that in the UK (where the capital gains tax is a separate tax) the law seems even more complex than in the US, Australia, Canada and South Africa (where the capital gains tax is incorporated in the income tax).

Notable, too, in this respect are New Zealand and China. In New Zealand there is no tax on capital gains as such but capital gains are in some circumstances treated as taxable income. That there is no tax on capital gains as such is widely regarded as a shortcoming, but that taxable capital gains are simply treated as ordinary income is instructive. Since the rules applicable to taxable capital gains are often the same rules as apply to ordinary income, it would make little sense for there to be a separate capital gains tax. There has been much debate over the years in

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47 Internal Revenue Code, 26 USC (1986).
48 *Income Tax Assessment Act 1997* (Cth) pts 3.1 and 3.3.
49 *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), sub-div C.

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New Zealand as to the possibility of introducing a capital gains tax, but this has so far come to nothing—other than the provisions extending the definition of income to cover some types of capital gains.[50]

Similarly in China, there is no tax on capital gains as such, but the Chinese system of income tax generally does not distinguish between income and capital gains and some kinds of capital gains are treated as ordinary income. In particular, both individuals and firms are taxed on 'income from transfer of property' and this term is defined broadly enough to catch most capital gains.[51] As in New Zealand, there has been debate in China in recent years as to the possibility of introducing a capital gains tax but this has to date led to nothing. It is unclear whether, if the Chinese government were to introduce a capital gains tax, it would be a part of the income tax system or a separate tax.

IV. REALIZATION OR ACCRUAL?

It is widely thought that it might be preferable in principle to tax capital gains on an accrual or mark-to-market basis rather than on the basis of realization.[52] That is, taxpayers should be taxed every year on the increase in the value of their capital assets, rather than when they realize a gain by selling or otherwise disposing of an asset. Taxing on an accruals basis would have a number of advantages, but none of the countries reviewed in this book has based its capital gains tax principally on accruals. That is, despite the advantages that might come with taxing on an accruals basis, the existing capital gains taxes are all based principally on realization. In other words, the liability to tax generally arises only when the asset in question is sold or otherwise disposed of. One reason for this is that, whilst tax professionals and economists tend to find the accruals principle enduringly appealing, many other people seem to regard the idea of taxing unrealized gains as self-evidently and alarmingly objectionable. Nonetheless, some countries do tax on an

[50] See Chapter 9 of this book (New Zealand). See also Shelley Griffiths, '"The Game is Not Worth the Candle": Exploring the Lack of a Capital Gains Tax in New Zealand' (2015) 21 NZJTLP 51; Melinda Jacomb, 'A History of Taxing Capital Gains in New Zealand: Why Don't We?' (2014) 20 Auckland U L Rev 124.

[51] Individual Income Tax Law 1980 (China), art 2(9); Enterprise Income Tax Law 2007 (China), art 6(3).

[52] See Chapter 2 of this book (The impact of economic theory on capital gains tax reform proposals).

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accruals basis in some circumstances—most commonly, in the case of listed securities and some forms of debt instrument.[53]

The advantages of taxing capital gains on an accruals basis include the following. First, it accords with the Haig-Simons principle and thus with ability to pay.[54] One of the main reasons for taxing income (and for not exempting capital gains) is that liability correlates, broadly speaking, with the taxpayer's ability to pay; and the idea that liability should correspond with ability to pay is widely regarded as a basic tenet of tax equity. All else being equal, a person whose net wealth has increased has a greater ability to pay than one whose net wealth has not increased—even if he or she has not realized the increase by selling the asset in question. If the appropriate time to tax the gain is as it accrues, then to defer the liability to pay the tax until the gain is realized is to confer on the taxpayer an unjustified benefit, in that he or she has the use of the money in the meantime. Taxing on the basis of accruals would in some circumstances cause serious inconvenience (because of problems of valuation and liquidity), and for that reason it might be desirable—even if a capital gains tax were to be based on accruals—to mitigate the effect in some circumstances. But that is not a reason for abandoning the accruals concept entirely.

Secondly, taxing capital gains as they accrue would eliminate the 'lock-in' effect produced by a realization-based capital gains tax. If capital gains are taxed only when they are realized (rather than as they accrue), there is an incentive for taxpayers to retain assets that they would otherwise sell, because by retaining them they can defer their liability to pay tax. In other words, taxing capital gains only upon realization allows taxpayers the use of the funds in the meantime; taxing capital gains as they accrue would deprive them of that advantage. Most of the countries discussed in this book provide some form of 'rollover' relief, which mitigates this problem, but does not eliminate it (see part XVIII below).

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[53] See, for example, Income Tax Act 2007 (New Zealand), subpt EW; Internal Revenue Code, 26 USC §§ 475, 817A, 1256 and 1296 (1986); Income Tax Act, 58 of 1962 (South Africa), sch 8, para 13.

[54] See generally Henry Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (University of Chicago Press 1938).

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V. DEEMED REALIZATIONS

Most countries support the realization criterion with rules deeming a realization at market value to have occurred in various circumstances. For example, most countries (though, notably, not the US) treat death as entailing a disposition at market value of the property owned by the deceased.[55] Similarly, most countries (for example, the US and Australia) treat gifts as a disposition at market value.[56]

VI. JURISDICTION TO TAX

The income taxes of most of the countries discussed in this book are based on both residence and source. That is, persons resident in the jurisdiction are liable to pay tax on their worldwide income (meaning income derived from within the jurisdiction and also income derived from outside it), and income derived from within the jurisdiction is taxable even if the person to whom it accrues is not resident there. This is so in the US, the UK, Canada, Australia, New Zealand,[57] South Africa[58] and China.[59] In the case of the US, liability is also based on citizenship. That is, a US citizen is liable to pay tax on his or her income even if he or she is not resident in the US and the income is derived from outside the US.[60] The Netherlands' tax system is, unlike the others discussed in

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[55] See, for example, *Income Tax Assessment Act 1997* (Cth) ss 128-10 and 128-15; *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), s 70(5)(a); Inheritance and Gift Tax Act 1956 (the Netherlands), art 1; Income Tax Act, 58 of 1962 (South Africa), sch 8, para 11; Taxation of Chargeable Gains Act 1992 (UK), s 62.

[56] See, for example, Income Tax Act, 58 of 1962 (South Africa), sch 8, para 11; Internal Revenue Code, 26 USC § 1015 (1986); Inheritance and Gift Tax Act 1956 (the Netherlands), art 1; *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), s 69(1)(b)(ii) and (c); *Income Tax Assessment Act 1997* (Cth) s 112-20.

[57] Ernst & Young, 'The 2011 Global Executive: Individual Tax, Social Security and Immigration' (2011) <www.ey.com> accessed 22 March 2017.

[58] Income Tax Act, 58 of 1962 (South Africa), sch 8, para 2(1)(b) and 2(2).

[59] Individual Income Tax Law 1980 (China), art 1, paras 1–2; Regulations for Implementation of the Individual Income Tax Law of the People's Republic of China (promulgated by State Council, 28 January 1994, effective 28 January 1994), arts 2–3.

[60] Internal Revenue Code, 26 USC §§ 1, 11, 7701 (1986).

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this book, based only on source. That is, income derived by residents of the Netherlands from outside the country is not taxed.[61]

Most countries' capital gains taxes, however, are substantially narrower in scope than their income taxes. Residents are generally subject to capital gains tax on a worldwide basis. That is, a person resident in the taxing jurisdiction is subject to tax even if the property in respect of which the gain is made is situated in some other country. This is so of the US,[62] the UK,[63] Canada,[64] Australia,[65] South Africa,[66] China[67] and New Zealand[68] (except that New Zealand taxes only some classes of capital gains), but not the Netherlands.

The 'source' aspect of a capital gains tax, however, is usually more narrowly defined. Non-residents are generally taxed on gains made on disposals of land situated within the taxing jurisdiction; and if a non-resident has a permanent establishment in the taxing jurisdiction, it is usually taxed on gains made on disposals of assets used by the permanent establishment.[69] But non-residents are often not taxed on gains made on disposals of other kinds. Most importantly, most countries generally do not tax capital gains made by non-residents on the disposal of securities (unless the taxpayer has a permanent establishment in the taxing country and the securities are held by the permanent

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61 See Chapter 8 of this book (the Netherlands).

62 Internal Revenue Code, 26 USC §§ 1, 11, 7701 (1986).

63 Taxation of Chargeable Gains Act 1992 (UK), ss 2 and 9–14.

64 *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), art 2.

65 *Income Tax Assessment Act 1997* (Cth) s 6.5.

66 Income Tax Act, 58 of 1962 (South Africa), sch 8, para 2(1)(b) and 2(2).

67 Individual Income Tax Law 1980 (China), art 1, para 1; Regulations for Implementation of the Individual Income Tax Law (n 59), arts 2–3.

68 Income Tax Act 2007 (New Zealand), s BB 1 and pt C.

69 See, for example, Income Tax Act, 58 of 1962 (South Africa), sch 8, para 2(1)(b) and 2(2); *Income Tax Assessment Act 1997* (Cth) ss 855-10 and 855-20 item 3; Convention between Canada and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income (Wellington, 3 May 2012), *entered into force* 26 June 2015, art 13(2); Public Announcement Regarding Certain Enterprise Income Tax Matters on Indirect Transfer of Properties by Non-resident Enterprises (Gonggao [2015] 7, promulgated by State Administration of Taxation, 3 February 2015, effective 3 February 2015).

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establishment). That is so of the US,[70] the UK,[71] Canada,[72] Australia,[73] South Africa,[74] the Netherlands,[75] China[76] and New Zealand.[77] In India, gains made by non-residents on disposals of shares are generally taxable, but in some circumstances at lower rates than would apply to residents.[78]

The fact that non-residents are generally not taxed on capital gains made on securities means that, in the case of non-residents, the capital gains tax is in effect confined to gains made on the sale of land (including buildings and also interests in land and buildings) and gains made on disposals of securities held by a permanent establishment.[79] However, most countries also have rules relating to land-holding companies—for example, the US,[80] Australia[81] and China.[82] That is, whilst gains made by non-residents on disposals of shares (and other securities) are generally not taxable, such gains *are* taxable if the assets of the company in question consist mainly of land.

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70 Internal Revenue Code, 26 USC §§ 865 and 897 (1986).

71 Taxation of Chargeable Gains Act 1992 (UK), pt IV.

72 *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), s 248(1) 'taxable Canadian property' and Convention between Canada and New Zealand (n 69), art 13(2).

73 *Income Tax Assessment Act 1997* (Cth) div 855 and s 855-20 item 3.

74 Income Tax Act, 58 of 1962 (South Africa), sch 8, para 2(1)(b) and 2(2).

75 Personal Income Tax Act 2001 (the Netherlands), arts 7.2(2)(a), 7.3 and 7.4, in conjunction with arts 2.10 and 2.10a.

76 Notice on the Issue of Provisionally Exempting Gains Derived by QFIIs and RQFIIs in China from the Transfer of Securities and Other Equity Assets from Enterprise Income Tax (Caishui [2014] 79, promulgated by Ministry of Finance, State Administration of Taxation and China Securities Regulatory Commission, 31 October 2014, effective 17 November 2014); Circular on Tax Policies Relevant to the Pilot Project for the Mechanisms to Provide Mutual Trading Access between the Shanghai and Hong Kong Stock Markets (Caishui [2014] 81, promulgated by Ministry of Finance, State Administration of Taxation and China Securities Regulatory Commission, 31 October 2014, effective 17 November 2014).

77 Chapter 9 of this book (New Zealand).

78 Section 115AD, Income-tax Act, 1961 (India). See also Chapter 7 of this book (India).

79 Income Tax Act, 58 of 1962 (South Africa), sch 8, para 2(1)(b) and 2(2).

80 Internal Revenue Code, 26 USC § 897 (1986).

81 *Income Tax Assessment Act 1997* (Cth) ss 855-25 and 855-30.

82 Public Announcement Regarding Certain Enterprise Income Tax Matters on Indirect Transfer of Properties by Non-resident Enterprises (n 69).

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VII. EMIGRATION AND IMMIGRATION

The jurisdictional scope of most countries' capital gains taxes is supported by some form of exit tax. In the absence of such a tax, it would commonly be possible to escape the tax on a capital gain by *first* becoming non-resident and *then* selling the asset or assets in question (and perhaps then becoming resident again). Exit taxes prevent this, or at least make it more difficult. Becoming non-resident usually entails considerable inconvenience but it is a measure taxpayers might, in the absence of an exit tax, commonly be prepared to take because of the once-in-a-lifetime nature of the avoidance that would be possible. Examples include the UK and Australia.[83]

VIII. RATES OF TAX

Most countries use broadly similar rules for calculating the amount of a capital gain. Generally the amount of the gain is the amount of the proceeds realized when the asset is sold or otherwise disposed of, less the cost base. The cost base is typically the price paid by the taxpayer when he or she acquired the asset plus: associated costs such as legal fees paid at the time of purchase, expenditure incurred on improvements, and holding costs (such as interest).[84] If expenditure has been deducted for income tax purposes, the taxpayer generally cannot include it in the cost base for the asset. To do so would effectively amount to a double deduction.[85]

In most of the countries discussed in this book, capital gains are taxed at lower rates than apply to other income—at least in the hands of natural persons. Examples include the UK,[86] the US,[87] Canada,[88] Australia[89] and

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[83] See Chapter 11 of this book (the UK) and *Income Tax Assessment Act 1997* (Cth) s 855-10.

[84] See, for example, *Income Tax Assessment Act 1997* (Cth) s 110-25; s 48, Income-tax Act, 1961 (India); Income Tax Act, 58 of 1962 (South Africa), sch 8, paras 20 and 35.

[85] See, for example, *Income Tax Assessment Act 1997* (Cth) s 110-40(2); Income Tax Act, 58 of 1962 (South Africa), sch 8, paras 20 and 35.

[86] Tax rates (n 17).

[87] Internal Revenue Code, 26 USC § 1(h)(2) and 1(h)(9) (1986).

[88] Income Tax Act, RSC 1985 (Canada), c 1 (5th Supp), s 38.

[89] *Income Tax Assessment Act 1997* (Cth) sub-divs 115-C and 115-D, ss 106-5, 115-10, 115-25 and 115-100.

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South Africa.[90] The explanation for this preferential treatment seems to be generally historical and political, rather than principled.

IX. ASSET CLASSES

The main classes of capital assets are land (including buildings), shares and other securities, and chattels. The taxes discussed in this book generally apply to gains made on all three classes of assets. In every country, however, the rules differ according to the nature of the asset.

The most important classes of capital asset are land (including buildings) and securities (especially listed shares); and in most countries, and perhaps all, it is gains made on land and shares that produce almost the whole of the yield of the capital gains tax. However, the relative importance of land and shares varies considerably from country to country. In the US, the capital gains tax is principally a tax on securities, mainly because of the size of the US stock market and also because of the preferential treatment of owner-occupied housing. In the UK, Canada, Australia, New Zealand and South Africa the yield from taxing gains made on disposals of land is more important.[91]

The Chinese tax system distinguishes between those shares that are listed on one or other of the country's two stock exchanges (Shanghai and Shenzhen) and those that are not. Capital gains made on unlisted shares are generally taxable, whereas capital gains made on listed shares are specifically exempted.[92] Similarly, the Indian capital gains tax exempts capital gains (other than short-term capital gains) made on sales of listed shares.[93]

X. DEATH

The best and simplest way for a capital gains tax to deal with death is to treat it as a disposal. That is, the deceased is treated as having disposed of all of his or her assets, thus giving rise to a liability to tax (assuming

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[90] See Chapter 10 of this book (South Africa), part I.

[91] See Chapters 4, 5, 9, 10, 11 and 12 of this book (Australia, Canada, New Zealand, South Africa, the UK and the US).

[92] Circular on Tax Policies Relevant to the Pilot Project for the Mechanisms to Provide Mutual Trading Access between the Shanghai and Hong Kong Stock Markets (n 76).

[93] Section 10(38), Income-tax Act, 1961 (India).

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the circumstances are such that the sale or other disposition of the assets would have given rise to a liability). Such liability is based on the value of the assets at the time of death, less the basis (meaning typically the price when purchased plus other relevant expenditure). Another possible approach is to defer liability until the asset in question is sold or otherwise disposed of by the person inheriting it, but still using the deceased's basis. That is, no liability to capital gains tax arises until the person inheriting the asset sells it; but at that point the gain is quantified by taking the sale price and deducting the deceased's basis (that is, typically, the price paid by the deceased plus other relevant expenditure).

Most of the capital gains taxes discussed in this book take the former approach—that is, death is treated as a disposal giving rise to a liability. This is so in, for example, Canada[94] and South Africa.[95] Australia, in contrast, takes the other approach. That is, no liability to capital gains tax is triggered by death. If the deceased acquired the asset in question on or after 20 September 1985 (when the tax came into force), the person inheriting it is treated as having the same cost base as the deceased.[96] If the deceased acquired the asset on or before that date, the basis of the person inheriting is the value of the asset as at the date of the deceased's death. In other words, death does not deprive a person of the preferential treatment accorded to assets acquired before 20 September 1985.

The exception is the US, where:

1. death is not treated as a disposal (so no liability to capital gains tax arises) at the time of death;
2. the person inheriting the asset is (depending on the circumstances) liable for capital gains tax when he or she sells it; and
3. the liability then arising is calculated on the basis of the sale price less the value of the asset at the time of the deceased's death.[97]

Thus, the gain accruing from when the deceased acquired the asset until the time of his or her death escapes tax altogether. In other words, under the US system there is a powerful incentive for taxpayers to retain appreciating capital assets until they die. This is presumably seriously distortionary.

Similarly in the UK, death generally does not give rise to a liability to capital gains tax. It does however typically give rise to a liability to

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94 *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), s 70(5)(a).
95 Income Tax Act, 58 of 1962 (South Africa), sch 8, para 12A.
96 *Income Tax Assessment Act 1997* (Cth) s 128-15(4) item 4.
97 Internal Revenue Code, 26 USC §§ 1001(a) and 1014 (1986).

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inheritance tax. As in the US, the person inheriting is taken as having acquired the asset at its value as at the time of death, so any gain that accrued from the time the deceased acquired the asset until his or her death is not taxed.[98]

XI. GIFTS

Gifts raise issues similar to those presented by death. For example, in the US, a gift is not treated as a disposal but the recipient generally takes over the donor's basis.[99] Thus, when the recipient disposes of the property gifted, he or she is taxed on the gain accruing from the time the donor acquired the property plus the gain accruing from when he or she (the donee) acquired it. In Australia the donor is treated as having disposed of the asset at market value and the donee is treated as having acquired it at the same value.[100] Similarly in the UK,[101] Canada[102] and South Africa,[103] a gift of a capital asset is treated as a disposal at market value.

XII. CORPORATIONS AND TRUSTS

Treatment of capital gains made by companies varies. For example, in Canada, companies are taxed on their capital gains in much the same manner as individuals.[104] Similarly in the Netherlands, corporations are taxed on capital gains in a manner largely comparable to that applicable to individuals, though under a different statute.[105] In the UK, in contrast, natural persons and trusts pay capital gains tax (a separate tax, in that country, from income tax) and companies pay corporation tax on 'chargeable gains'.[106] The scope of corporation tax on chargeable gains is similar to that of capital gains tax. Most countries also have rules dealing

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[98] Taxation of Chargeable Gains Act 1992 (UK), s 62.
[99] Internal Revenue Code, 26 USC § 1015 (1986).
[100] *Income Tax Assessment Act 1997* (Cth) s 116-30.
[101] Taxation of Chargeable Gains Act 1992 (UK), s 17.
[102] *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), s 69(1)(b)(ii) and (c).
[103] Income Tax Act, 58 of 1962 (South Africa), sch 8, para 11.
[104] *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), s 248(1) 'person'.
[105] Individuals are taxed under the Personal Income Tax Act 2001, corporations under the Corporate Income Tax Act 1969.
[106] Taxation of Chargeable Gains Act 1992 (UK), s 8.

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with trusts. For example, in South Africa, gains made by trusts can be attributed to beneficiaries, but losses cannot.[107]

XIII. LOSSES

Most countries allow losses to be carried forward and set off against future capital gains. Some, for example Canada, also allow losses to be carried back.[108] Most countries 'ring-fence' capital losses: that is, taxpayers are allowed to set off capital losses against capital gains but they are not allowed to set off capital losses against ordinary income. The reason for this is to prevent 'cherry picking'. If taxpayers were allowed to set off capital losses against ordinary income, there would be a strong incentive for them to realize capital losses (by selling assets that had fallen in value) so as to set the loss off against ordinary income, whilst retaining assets that had risen in value (thus deferring the liability to tax). For example, the US,[109] British,[110] Canadian,[111] Australian[112] and South African[113] systems operate in this way.

XIV. DOUBLE TAX TREATIES

Most countries other than tax havens have more or less comprehensive networks of bilateral double tax agreements (DTAs). Almost all such treaties are based on a Model Tax Convention (the Model) produced by the OECD.[114] Article 13 of the Model deals with capital gains. It provides for what is to happen when a person resident in one of the contracting states makes a gain on the disposal of a capital asset situated in the other contracting state.

Some DTAs incorporate art 13 verbatim, or more or less verbatim; others, however, do not follow it precisely, or at all. The differences between DTAs can give rise to various difficulties as to the scope of the

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[107] Income Tax Act, 58 of 1962 (South Africa), sch 8, para 80.
[108] *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), s 41(2)(b).
[109] Internal Revenue Code, 26 USC §§ 1(h) and 1211 (1986).
[110] Taxation of Chargeable Gains Act 1992 (UK), ss 2 and 16.
[111] *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), ss 111(1)(b), 111(1.1) and 111(8) (definition of 'net capital loss').
[112] *Income Tax Assessment Act 1997* (Cth) s 102-15.
[113] Income Tax Act, 58 of 1962 (South Africa), sch 8, paras 3–10.
[114] OECD, 'Model Convention with Respect to Taxes on Income and on Capital' (Paris, 2014) [OECD Model Tax Convention].

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contracting countries' capital gains taxes.[115] It can also give rise to the possibility of treaty shopping.[116]

XV. INFLATION

It is widely thought that equity requires that any tax on capital gains should allow for inflation. Whether this view is analytically sound is debatable; but whether sound or not, it is widely held. Several of the countries discussed in this book have experimented with inflation-indexing their capital gains taxes (for example, the UK and Australia), but this has generally been found troublesome. As indicated above, however, capital gains are generally taxed at lower rates than apply to ordinary income and one of the justifications commonly offered for this preferential treatment is that it is a rough-and-ready means of allowing for inflation. The lack of inflation-indexing might also be partly justified on the basis that a realization-based capital gains tax (as opposed to an accruals-based one) gives taxpayers the benefit of deferral; and the benefit of deferral to some extent compensates for the lack of indexing. Of the countries discussed in this book, the only one whose capital gains tax currently provides for inflation-indexing is India.[117] Despite the problems encountered elsewhere, this aspect of the Indian capital gains tax appears relatively unproblematic.

XVI. PRINCIPAL FAMILY HOME

All of the countries discussed in this book provide for some form of preferential treatment for capital gains made on the sale of the taxpayer's residence. Taxpayers are generally entitled to this preferential treatment in respect of only one residence. In some countries, notably the UK,[118] Canada[119] and Australia,[120] the exemption is unlimited. In others, it is subject to a ceiling of some kind. For example, in the US the first US $250 000 of gain is exempt from tax for a single taxpayer and the first

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115 See Chapter 3 of this book (*International aspects of capital gains taxation*).
116 ibid.
117 Section 48, Income-tax Act, 1961 (India).
118 Taxation of Chargeable Gains Act 1992 (UK), s 223.
119 *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), s 40(2)(b).
120 *Income Tax Assessment Act 1997* (Cth) sub-div 118-B.

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US $500 000 is exempt for married taxpayers filing jointly.[121] Similarly in South Africa, only the first R2 million of gain is exempt. Typically, as in South Africa, for example, such preferential treatment is available only where the home is owned by a natural person.[122] That is, homes owned by companies and trusts are ineligible. In the US and the Netherlands the generous treatment of the taxpayer's home is compounded by generous rules relating to the deductibility of mortgage interest.[123] In China, the gain made by a taxpayer on his or her principal home is exempt, but only if he or she has owned it for more than five years.[124]

Complications arise where a taxpayer owns a home and lives in it for some periods and rents it out for others. Most countries—for example, the UK[125] and Canada[126]—require some form of apportionment in such cases. Similar complications arise where a taxpayer uses a property partly as a residence and partly for the carrying on of a business. Again, this is typically dealt with by means of apportionment—as in Australia, for example.[127] Farms and lifestyle blocks present particular difficulties, typically dealt with by means of specifying a maximum area of land that a taxpayer can count as his or her residence (the remainder of the property not qualifying for preferential treatment). In South Africa, for example, the limit is 2 hectares.[128]

There appears to be little in the way of any persuasive principled justification for the preferential treatment afforded to taxpayers' principal residences. Rather, the preference is no more than an expedient to counter political opposition. Moreover, such preferences are widely regarded as seriously problematic. They are inequitable, in that they discriminate between homeowners and renters; and they undermine the progressivity of the tax system. They also encourage overinvestment in owner-occupied housing—an unproductive class of assets (a phenomenon sometimes referred to as the 'mansion effect').

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121 Internal Revenue Code, 26 USC § 121 (1986).

122 Income Tax Act, 58 of 1962 (South Africa), sch 8, paras 44–51A.

123 See Internal Revenue Code, 26 USC § 163 (1986); Personal Income Tax Act 2001 (the Netherlands), art 2.10(2).

124 *Notice on Individual Income Tax on Incomes from Transfer of Individuals' Houses* (Guoshuifa [2006] 108, promulgated by State Administration of Taxation, 18 July 2006).

125 Taxation of Chargeable Gains Act 1992 (UK), s 223(4).

126 *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), s 40(2)(b).

127 *Income Tax Assessment Act 1997* (Cth) s 118-190.

128 Income Tax Act, 58 of 1962 (South Africa), sch 8, para 46.

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XVII. DE MINIMIS EXEMPTIONS

Some countries, but not all, have de minimis rules. For example, the UK has an annual exempt allowance of slightly over £10 000,[129] Canada has a de minimis threshold of C $1000 for 'personal-use property'[130] and Australia effectively exempts personal use assets worth less than AU $10 000.[131]

XVIII. THE LOCK-IN EFFECT AND ROLLOVER RELIEF

Since existing capital gains taxes base liability mainly on realization rather than accrual, they encourage taxpayers to retain assets that they would otherwise sell. This 'lock-in' effect is generally regarded as economically inefficient and most countries' capital gains taxes therefore provide for some form of relief from it, referred to as 'rollover relief'. That is, in some circumstances, a taxpayer who realizes a capital gain that would otherwise be taxable is not taxed on it if he or she reinvests the proceeds of sale in another asset of the same kind as that disposed of. Examples include the US,[132] the UK,[133] Canada[134] and China.[135] Rules providing for advantageous tax treatment naturally attract abuse. That is, taxpayers commonly attempt to arrange their affairs so as to qualify for

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[129] Taxation of Chargeable Gains Act 1992 (UK), s 3(4); HM Revenue and Customs, 'Capital Gains Tax rates and annual tax-free allowances' (guidance, April 2016).

[130] *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), s 46(1).

[131] *Income Tax Assessment Act 1936* (Cth) s 118-10.

[132] Internal Revenue Code, 26 USC §§ 354, 355, 356, 357, 358, 361, 362, 368, 1031, 1033 and 1041 (1986).

[133] Taxation of Chargeable Gains Act 1992 (UK), ss 58, 126–131, 152 and 171.

[134] *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), ss 44(1), 44.1, 55(2)–(3.3), 70(6), 73(1), 87–88 and 98(3)–(5).

[135] *Notice Regarding Several Issues on the Enterprise Income Tax Treatment of Enterprise Restructuring* (Caishui [2009] 59, promulgated by Ministry of Finance and State Administration of Taxation, 30 April 2009, effective 1 January 2008), art 5; *Public Announcement Regarding the Administration of Enterprise Income Tax for Corporate Reorganization* (Gonggao [2010] 4, promulgated by State Administration of Taxation, 26 July 2010, effective 1 January 2010); *Notice Regarding Enterprise Income Tax Treatment for Encouraging Enterprise Restructuring* (Caishui [2014] 109, promulgated by Ministry of Finance and State Administration of Taxation, 25 December 2014, effective 1 January 2014).

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the relief in circumstances other than those intended by the legislature. The rules providing for rollover relief are therefore typically supported by rules intended to prevent their abuse; consequently the legislation dealing with rollover relief is generally complex.

XIX. AVOIDANCE

Like all taxes, capital gains taxes are potentially susceptible to avoidance. Most countries' capital gains taxes have been undermined to some extent by taxpayers' attempts to escape liability by temporarily ceasing to be resident (in particular because gains made by non-residents on sales of securities are typically not taxable) and by using non-resident entities (trusts or companies) to hold assets (particularly shares) sited within the jurisdiction. Some countries—for example, the UK—have promulgated complex rules aimed at preventing such abuses. The UK has also on several occasions enacted legislation overriding its DTAs to prevent taxpayers sheltering behind DTAs to avoid tax.[136] Similarly, Canada has a number of specific anti-avoidance rules (SAARs) aimed at preventing particular methods of avoidance.[137]

A more general and perhaps larger problem is produced by the fact that most countries tax capital gains at lower rates than are applied to ordinary income. That means that there is an incentive for taxpayers to adopt arrangements designed to convert ordinary income (taxable at a higher rate) into capital gains (taxable at a lower rate). Consequently, the central problem is not that taxpayers seek to avoid the tax on capital gains, but that they seek to have their ordinary income taxed as capital gains; that is, they attempt to pay capital gains tax rather than income tax.

Measuring the extent of tax avoidance of this kind seems to present insuperable methodological difficulties but it is generally thought that it is a serious problem in most of the countries discussed in this book. In most countries the legislation aimed at preventing this kind of avoidance is complex; and so, moreover, are the transactions that taxpayers design to circumvent it. It seems reasonable to assume, therefore, that the deadweight loss attributable to the preferential treatment of capital gains is considerable.

As also explained above, most countries restrict the use of capital losses. That is, taxpayers can generally set off capital losses against

[136] See Chapter 11 of this book (the UK), parts II, III and IV.

[137] See, for example, *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), ss 55(2) and 212.1.

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capital gains but not against ordinary income. Consequently, just as there is an incentive for taxpayers to convert ordinary income into capital gains, so too is there an incentive for them to adopt arrangements designed to convert capital losses (which generally cannot be set off against ordinary income) into losses of an income nature (which can). Again, it is difficult to measure the scale of this problem but it seems reasonable to suppose that it is considerable.

Most countries have mechanisms intended to restrict abuses of these sorts. Rules aimed at preventing avoidance have typically added considerably to the taxing legislation's complexity. For example, most countries have statutory rules directed at particular methods of converting ordinary income into capital gains.[138] Some countries, notably Australia, Canada, South Africa, the UK and China, have general anti-avoidance rules (GAARs)—that is, rules directed at tax avoidance as such. In Australia, for instance, it would seem that the GAAR provided for in the income tax legislation[139] could in principle apply to schemes designed to avoid capital gains tax,[140] though there seem to be no reported cases in which that has happened. The US does not have a GAAR, but the US courts have developed a raft of anti-avoidance doctrines—the economic substance doctrine, the substance over form doctrine, and the step transaction doctrine.[141] Netherlands law has the 'abuse of law' principle, which has been applied so as to counteract attempts to avoid capital gains tax.[142] The Chinese tax treatment of capital gains is supported by domestic transfer pricing rules.[143]

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[138] See, for example, Internal Revenue Code, 26 USC §§ 1258–1260 (1986).

[139] *Income Tax Assessment Act 1936* (Cth) pt IVA.

[140] See *Federal Commissioner of Taxation v Macquarie Bank Ltd* [2013] FCAFC 13 (15 February 2013).

[141] See *Gregory v Helvering* 293 US 465 (1935); *Commissioner of Internal Revenue v Clark* 489 US 726, 738 (1989); *Frank Lyon Co v United States* 435 US 561, 583–84 (1978); *Neonatology Associates PA v Commissioner of Internal Revenue* 299 F 3d 221, 230 (3rd cir 2002). See generally *Rogers v United States* 281 F 3d 1108, 1115–17 (10th cir 2002).

[142] Known as fraus legis. There is also a statutory general anti-abuse rule: General Taxes Act, art 31; applied, for example, in HR 27 December 1967, *BNB* 1968/80.

[143] *Administrative Measures of Matters regarding Individual Income Tax on Income Derived from the Alienation of Shares (Trial)* (Gonggao [2014] 67, promulgated by State Administration of Taxation, 7 December 2014, effective 1 January 2015); *Notice on Individual Income Tax on Incomes from Transfer of Individuals' Houses* (n 124).

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As indicated above, the differences between different countries' DTAs seem in some circumstances to permit treaty shopping. That is, a person resident in Country A might use a company or other entity set up in Country B to invest in Country C (rather than investing directly in Country C), so as to get the benefit of the DTA between Country B and Country C. Depending on the circumstances, such an arrangement might enable the person to reduce or escape altogether his or her liability to tax in Country A or Country C or both.[144] The extent to which different countries' capital gains taxes might be proof against avoidance of this kind is a difficult question.[145]

XX. ADMINISTRATION

Capital gains taxes appear to be generally more expensive to administer, per dollar of tax collected, than income taxes. They appear also to impose a heavier compliance burden on taxpayers, per dollar of tax paid. The reasons for this seem to be, first, that capital gains taxes are generally collected directly from the taxpayer, rather than by imposing withholding obligations on persons making payments to the taxpayer. Secondly, capital gains are typically realized occasionally and sporadically, whereas income tends to be more or less regular. Consequently, the taxpayer and the taxing authority typically both find it necessary to give particular attention to the tax consequences of capital transactions, whereas the payment and collection of income tax is generally more or less routine. The main category of income not taxable by means of withholding is business profits; but even companies and individuals whose income is volatile usually have routines in place for calculating and paying the tax on it.

On the other hand, capital gains taxes to some extent deter taxpayers from adopting arrangements calculated to convert taxable income into capital gains, which in the absence of a capital gains tax would not be taxable at all. Since capital gains taxes are generally charged at lower rates than income taxes, such arrangements still produce tax savings, but

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[144] See, for example, M Littlewood and K Rainsford, 'Hong Kong's Treaty Network: Are the US, Germany and Australia Sensibly Standing Aloof? Or Sadly Missing Out?' [2014] BTR 72.

[145] See, for example, Australian Taxation Office, *Income tax: can the profit on the sale of shares in a company group acquired in a leveraged buyout be included in the assessable income of a vendor under subsection 6-5(3) of the Income Tax Assessment Act 1997?*, TD 2010/21, 1 December 2010.

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much less so than if capital gains were not taxed at all. Thus, whilst capital gains taxes are relatively expensive to administer, the cost can be regarded as part of the cost of shoring up the income tax.

XXI. TRANSITIONAL ARRANGEMENTS

One problem presented by the introduction of a capital gains tax is, what should be done about assets owned by taxpayers at the time the tax is introduced? The usual solution seems to be to tax the gain but to allow a deduction for the value of the asset at the time the tax was introduced. In other words, the gain accruing from the introduction of the tax until the sale is taxed; but not the gain accruing from the date the asset was acquired until the date the tax came into effect. This approach was used in, for example, the UK.[146] South Africa dealt with this problem by providing for three different methods of determining the base of assets held at the introduction of the tax (1 October 2001).[147]

The Australian approach to this aspect of the design of the tax is instructively weak. There, in order to meet the charge that the tax was retrospective, gains made on all assets acquired before the introduction of the tax (20 September 1985) were and remain exempt. There is consequently a powerful incentive for taxpayers to retain assets acquired before that date.[148]

XXII. CONCLUSION

It is notable that most of the capital gains taxes examined in this book suffer from what seem to be obvious flaws. In the US, the most obvious flaw is perhaps the wholesale exemption of assets held at death.[149] As one would expect, this exerts a powerful and unproductive lock-in effect and presumably results in considerable inequity and a significant loss of revenue. The British capital gains tax is similarly defective. The UK system's other obvious shortcoming is the general exemption of non-residents.[150] This would seem to have encouraged inwards foreign investment, but it would also seem to undermine the system's equity and

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[146] See Chapter 11 of this book (the UK), part II.
[147] Income Tax Act, 58 of 1962 (South Africa), sch 8, paras 24, 30 and 97.
[148] *Income Tax Assessment Act 1997* (Cth) s 104-230.
[149] Internal Revenue Code, 26 USC § 1014 (1986).
[150] Taxation of Chargeable Gains Act 1992 (UK), ss 9–14.

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to entail a significant loss of revenue. In Australia, the obvious flaw is the wholesale exemption of gains made on assets acquired before 1985.[151] The distinctive flaw in the Canadian capital gains tax seems to be the exemptions available in respect of 'qualified farm property', 'qualified fishing property' and 'qualified small business corporation shares'. These are extremely complex and encourage unproductive, tax-driven transactions that are expensive for taxpayers to undertake and for the tax authority to police.[152]

In New Zealand, whilst some capital gains are treated as income and taxed accordingly, there is no tax on capital gains as such.[153] The New Zealand system is, however, better than most in one respect: those capital gains that are taxable are taxed at the same rates as apply to ordinary income. But the non-taxation of most capital gains is widely regarded as grossly inequitable and seriously inefficient. In the Netherlands, the 'box' system results in different kinds of capital gains being taxed at very different rates;[154] and Box 3, in particular, is widely regarded as problematic.[155] As for China, the problem is not so much any particular design flaw, as that the legislation, both the Individual Income Tax Law 1980 and the Enterprise Income Tax Law 2007, leaves important issues unresolved; and that the resulting lacunae have been filled by administrative measures issued in a rather ad hoc manner. This is, however, characteristic of the Chinese tax system generally, and indeed the Chinese legal system generally.[156] By the criteria of the West, the Chinese approach seems problematic—but it seems not to be impairing China's economic growth.[157] Whether it is sustainable in the longer term remains to be seen.

The exception is South Africa. South Africa's capital gains tax seems to have no serious flaws—at least if one accepts the prevailing views as to how capital gains ought to be taxed. That is, the South African capital gains tax, like the other capital gains taxes discussed here, assumes that a capital gains tax should be based on realization rather than accruals; that capital gains should be taxed at lower rates than ordinary income; that gains made on a taxpayer's principal residence should be given some

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[151] *Income Tax Assessment Act 1997* (Cth) s 104-230 and div 149.
[152] *Income Tax Act*, RSC 1985 (Canada), c 1 (5th Supp), s 110.6.
[153] Income Tax Act 2007 (New Zealand), subpt CB.
[154] See Chapter 8 of this book (the Netherlands), part III.
[155] ibid.
[156] See Chapter 6 of this book (China).
[157] See, for example, Linda Yueh, *China's Growth: The Making of an Economic Superpower* (Oxford University Press 2013).

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form of preferential treatment; and that gains made by non-residents on disposals of securities should not be taxed (leaving aside land-holding companies and permanent establishments). But if it is accepted that a capital gains tax should operate within those parameters, the South African capital gains tax seems to have no serious flaws. The lesson, perhaps, is that South Africa, by not introducing a capital gains tax until relatively recently, has been able to benefit from other countries' mistakes. It might be said that the South African capital gains tax does not make sufficient allowance for inflation, but even if this point is accepted, it would seem to be a relatively minor shortcoming.[158]

Other lessons that might be learned from the experiences of the countries reviewed in this book include the following. First, it would seem to be preferable for a capital gains tax to be incorporated in the income tax system, rather than separate from it. This conclusion is borne out both by the UK (where the capital gains tax is a separate tax) and by the other countries (where the capital gains tax is part of the income tax).

Secondly, the rates at which capital gains are taxed are generally too low, relative to the rates at which ordinary income is taxed. It is possible that the optimal approach would be to tax capital gains at the same rates as ordinary income. That would eliminate the incentive to convert ordinary income into capital gains. Consequently, it would presumably also eliminate much unproductive game-playing and significant losses in revenue. According to some, taxing capital gains at the same rates as ordinary income would also be appropriate as a matter of principle. The more commonly accepted view, however, is that capital gains should be taxed at lower rates than ordinary income, either as a matter of principle (as an approximate allowance for inflation) or as a matter of political necessity (for it seems difficult to persuade voters that it would be appropriate to tax capital gains at the same rates as ordinary income). But even if it is appropriate to tax capital gains at lower rates than ordinary income, it seems plain that in most countries the margin is wider than it should be.

Thirdly, whilst basing a capital gains tax on accruals rather than on realization would seem to be desirable in principle, no country has succeeded in doing it. Several countries have, however, adopted an accruals basis in some circumstances—for example, in dealing with listed

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[158] See Chapter 10 of this book (*South Africa*).

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securities.[159] This would seem advantageous. The principle, then, would seem to be that a capital gains tax should be based on accruals except where that is impracticable. Where to draw the line is debatable. Clearly gains made on listed securities can be taxed on the basis of accruals; and therefore should be taxed on that basis. Equally, taxing gains made on owner-occupied housing even on realization is problematic; taxing them as they accrue would be even more so. The main difficulty, therefore, is in deciding the approach to take in respect of land held on capital account—that is, land that the owner either rents out or uses in carrying on his or her own business. There would not seem to be any real difficulty in taxing such gains on an accruals basis. That is, therefore, what ought to happen. As for gains made on shares in unlisted companies, taxing them on an accruals basis would commonly present considerable difficulties of valuation and liquidity; they should therefore be taxed only when realized. Taxing gains made on interests in unincorporated businesses would present similar difficulties of valuation and liquidity; again, therefore, such gains should be taxed only on realization.

Fourthly, the tax base should be as broad as possible. That is, there should be as few exemptions and preferences as possible. This proposition might seem obvious as a matter of principle but the experiences of the countries discussed in this book support it. The capital gains taxes discussed in this book all provide for some form of preferential treatment for the taxpayer's principal residence—typically, complete exemption. This is difficult to justify in principle, especially as it encourages overinvestment in a wholly unproductive class of assets. But even if difficult to justify in principle, preferential treatment for the taxpayer's principal residence seems inescapable for political reasons. Moreover, some degree of rollover relief is probably unavoidable and perhaps desirable. A de minimis exemption would likewise seem to be harmless. Beyond these, however, exemptions and preferences would seem to be unnecessary and undesirable. One reason for this is that exemptions and preferences cost revenue but, more importantly, taxpayers' attempts to take advantage of them lead to unproductive tax-driven transactions. In addition, legislatures' attempts to prevent abuse contribute substantially to the legislation's complexity and the demands on the resources of the tax authority. Examples include the Canadian exemptions for 'qualified

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[159] See Chapter 11 of this book (the UK); Internal Revenue Code, 26 USC §§ 475, 817A, 1256 and 1296 (1986); Income Tax Act 2007 (New Zealand), subpts EW and EX; Chapter 8 of this book (the Netherlands).

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farm property', 'qualified fishing property' and 'qualified small business corporation shares'; and the UK's exemption of gains made by non-residents on disposals of land situated in the UK.

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