Research Office
Legislative Council Secretariat

Information Note

Progressive taxes in selected places

IN10/20-21

1. Introduction

1.1 In the latest Budget, the Financial Secretary reported the largest ever fiscal deficit of HK$257.6 billion for the Financial Year 2020-2021. The Government is expected to run deficits until at least 2024-2025, an exceptionally long period for Hong Kong's fiscal landscape. This, coupled with Hong Kong's ageing population and narrow tax base, has rekindled discussions over the need to reform the tax regime[1]. Among others, it has been suggested that the introduction of progressive taxes on capital gains, dividends and luxury goods may help broaden the tax base[2] and replenish the public coffers. Meanwhile, there are others who are worried that progressive taxes might complicate Hong Kong's simple tax system and weaken its international competitiveness.

1.2 A tax is considered progressive if it imposes higher tax rates upon those with higher income or more wealth.[3] In recent decades, many developed economies have introduced progressive taxes to protect/broaden the tax base and strengthen the **equity** of the tax regime. Indicative of this trend, most Organisation for Economic Co-operation and Development ("OECD") economies have introduced some forms of capital gains tax ("CGT") and/or dividend tax, with some also levying taxes on luxury goods[4]. Nevertheless, any proposal for progressive taxes has to account for its **effectiveness** in raising more tax revenues, **complexity** of the regime in terms of its costs of administration and compliance, and **efficacy** in attracting investment and promoting business.

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1 In the 2021-2022 Budget, the Financial Secretary hinted at the need to consider new revenue sources or revising tax rates, but he ruled out any major changes in the short term.

2 Broadening the tax base means subjecting more gross income - such as capital gains - to taxation.

3 A tax may also be progressive if it is levied on activities that are more common amongst those with higher income or more wealth. See Varela (2016).

4 OECD economies like South Korea and Turkey have imposed taxes on luxury goods.

1.3 At the request of Hon Michael TIEN Puk-sun, the Research Office has prepared this information note to study the implementation of progressive taxes in selected places, with focus mainly on the taxation of capital gains. The information note begins by reviewing the recent discussions about tax reform in Hong Kong, followed by an overview of the global experiences in imposing progressive taxes on capital gains, dividends and luxury goods. It then studies the United Kingdom ("UK") and Australia which are early adopters of CGT, as evidenced by their introduction of broad-based and comprehensive taxes on capital gains as early as in 1965 and 1985 respectively. The study covers the design and implementation of CGT, followed by other issues of concern such as CGT's role in generating revenue and broadening the tax base.

2. Discussions on tax reform in Hong Kong

2.1 Hong Kong has all along maintained a simple and low tax regime based on the territorial source principle[5]. As part of the schedular income tax system, it levies taxes on business profits under profits tax, property rental income under property tax, and employment income under salaries tax. Other sources of income outside these schedules – such as capital gains and dividends – are not subject to direct tax. Nevertheless, Hong Kong also levies indirect taxes such as stamp duties[6, 7], general rates, and motor vehicle taxes[8].

2.2 As an open economy with a relatively narrow tax base[9], income taxes (i.e. profits tax and salaries tax) contributed an estimated 57.5% of Hong Kong's total tax revenue in 2020-2021.[10] As shown in **Figure 1**, when compared with

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5 According to this principle, only profits and/or income arising in or derived from Hong Kong are taxable.

6 The sale or transfer of property is generally subject to stamp duty. Since 20 November 2010, a Special Stamp Duty has been levied on the resale of residential properties held for 36 months or less, whereas a Buyer's Stamp Duty has been levied on residential properties by any person except a Hong Kong permanent resident since 27 October 2012. Moreover, since 5 November 2016, a flat rate of 15% has been chargeable on the transaction or market value of residential properties acquired by buyers who already owned at least one residential property.

7 In addition to properties, the Government also charges stamp duty on stock transfers at a rate of 0.1% on the value of the transaction, on both the buyer and the seller.

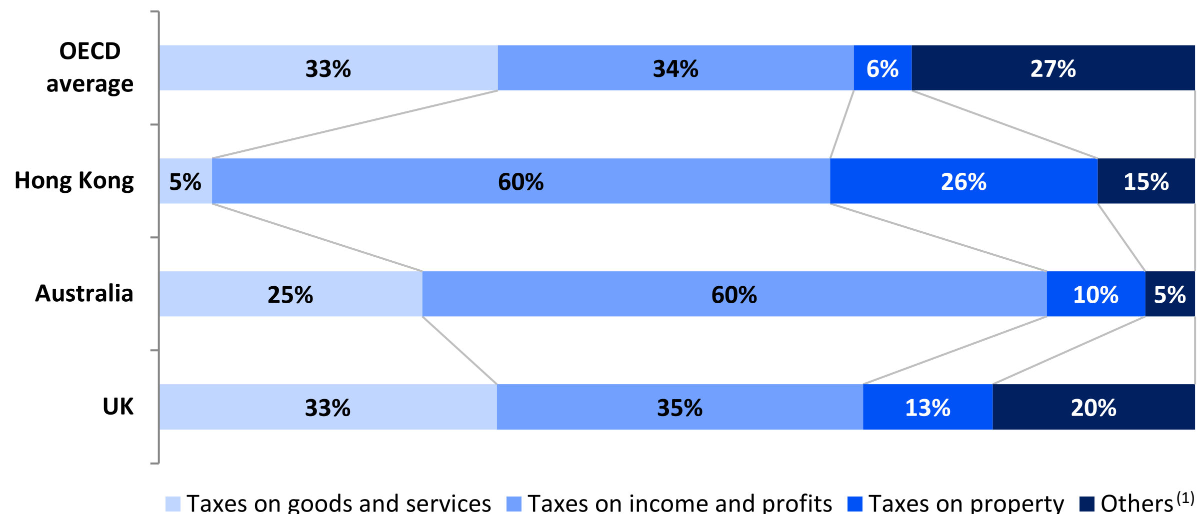
8 For instance, private vehicles are subject to a First Registration Tax at progressive rates.

9 A tax base is considered narrow if it is not sufficiently broad to protect the revenue from distortions and/or discriminatory effects of taxation on one form of economic activity as opposed to another. See Advisory Committee on Broad-based Taxes (2002).

10 The small tax-paying population also reflects the narrowness of Hong Kong's tax base. In the year of assessment 2018-2019, of the 3.86 million working population, only about 1.84 million (48%) were assessed as salaries taxpayers. See Financial Secretary's Office (2020).

the OECD average, Hong Kong's tax base is noticeably more reliant on taxation from property, personal income and corporate profits, and less dependent on taxes on goods and services[11]. Among others, the reliance on a narrow schedule of income taxes means that Hong Kong's tax revenue may suffer in the event of an economic downturn.

Figure 1 – Tax base in Hong Kong and OECD economies, 2018



Note: (1) The figure includes other taxes such as social security contributions and payroll taxes.
Sources: Census and Statistics Department (2021) and OECD Tax Database (2021).

Public consultation on tax reform in the 2000s

2.3 The Government launched public consultations in 2001 and 2006 respectively to solicit the public's view on the introduction of new types of broad-based taxes. Both consultations suggested that a broader and fairer revenue base help enhance the sustainability of Hong Kong's public finances. In particular, the Goods and Services Tax ("GST") was regarded as the primary option as it was broad-based, revenue productive, and less sensitive to economic or demographic changes.[12] Yet, significant concerns arose over the regressive nature of GST, i.e. low-income earners may face heavier financial burden since the same tax rate applied to individuals with different income

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11 In general, taxes on goods and services include value-added tax, sales tax, excises and other taxes levied on the import and export of goods.

12 It was further argued that GST at a rate lower than regional or international norms would have negligible impact on the competitiveness of Hong Kong. See Advisory Committee on New Broad-based Taxes (2002).

levels.[13] On 5 December 2006, the Financial Secretary announced that it had received negative public reaction to GST and as such, the Government would not advocate GST as the option to address the tax base problem.

2.4 Apart from the introduction of GST, the 2001 and 2006 consultations also explored whether it was feasible to introduce broad-based taxes on capital gains[14], dividends[15] and luxury goods[16], but ultimately ruled against these options.[17] In particular, the Government considered that a tax on **capital gains** would only yield limited revenue, be susceptible to adverse economic cycles, and compromise Hong Kong's simple tax system. Under the source-based system of taxation, taxpayers might also be encouraged to invest offshore in order to avoid tax liability on their capital gains. All in all, the Government considered that the potential costs of CGT outweighed its gains.

2.5 Both consultations also set out the concerns over the introduction of taxes on dividends and luxury goods. For instance, the introduction of **dividend tax** might give rise to double taxation of corporate income.[18] While double taxation may be mitigated by imputation and/or other relief measures,[19] it was seen as complex to legislate and difficult to administer. As for **luxury goods tax**, there were no commonly-accepted definition for luxury goods. The principle of horizontal equity may be violated if certain types of goods were taxed over others.

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[13] Against this, the Government had explained that the regressivity of GST could be mitigated via tax relief and compensation measures. See Financial Services and Treasury Bureau (2007).

[14] Some people consider that CGT can help broaden the tax base and bring additional revenue to the Government. Besides, this tax is fair as it applies to capital gains only and would not widen the wealth gap.

[15] Under the present tax system, it is possible for shareholding directors of large corporations, who may be very substantial income-earners, to escape personal taxation by receiving their income primarily through non-taxable dividends. A tax on dividends would, in principle, help to bring such people into the tax net and thus broaden the personal income tax base.

[16] Some people consider that insofar as luxury goods tax is levied on more valuable goods rather than necessities, it would not increase the burden of low-income earners and is in line with the "capacity to pay" principle.

[17] CGT and dividend tax were considered by the Advisory Committee on New Broad-based Taxes in the 2001 consultation, as well as by the Government in the 2006 consultation. As for luxury goods tax, it was considered in the 2006 consultation only.

[18] Under the classical dividend tax system, profits are first being taxed under the company, followed by the portion of profits distributed as dividends being taxed again in the hands of individual shareholders.

[19] In contrast to the classical system, a number of economies levy dividend tax through (a) full imputation where dividend tax credit is provided at shareholder level for underlying domestic corporate profits tax; or (b) shareholder relief where dividend income is taxed preferentially at the shareholder level. See Legislative Council Secretariat (2017).

Recent discussions on tax reform

2.6 During the latest Budget consultation, the Government has received a number of tax reform proposals amid the possibility of a surge in fiscal deficit to some HK$300 billion for 2020-2021. The proposals mooted include (a) increasing the progressivity of existing taxes; (b) introducing taxes on capital gains and/or dividends; and (c) taxing luxury goods.[20]

2.7 In general, the proponents of tax reform agree that any new tax proposals should target those with the capacity to pay. Yet, opinions differ as to the scope and extent of taxes to be introduced. There are proposals for taxing capital gains and dividends under a broad-based approach, as well as suggestions to introduce a CGT that only targets specific assets such as residential properties[21]. As to taxing luxury goods, there are some who favour this option to replenish public coffers by targeting those with higher income or more wealth. However, the proposal has raised concerns over its impact on related businesses. For instance, if an **ad valorem duty for wine** were re-introduced,[22] it might adversely affect Hong Kong's vibrant wine trading and distribution business.[23]

2.8 In view of the considerable financial pressure faced by individuals and businesses, the Financial Secretary has stated that it is not the appropriate time to introduce new taxes or adjust current tax rates. According to the Government, discussions will be facilitated at a suitable time and consensus forged before new taxes to increase revenue are to be introduced.[24]

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[20] For instance, see 明報(2021 年 1 月 8 日), 香港 01(2021 年 1 月 10 日) and 經濟日報(2021 年 1 月 15 日).

[21] Under this option, it has been suggested that CGT would replace the existing Special Stamp Duty targeted at short-term speculation of residential properties. CGT may be more appropriate as it would (a) only tax gains but not losses from the sale or transfer of property; and (b) levy taxes on long-term gains of more than 36 months which are not covered by the Special Stamp Duty. See 香港 01(2018 年 3 月 30 日) and 明報(2021 年 3 月 1 日).

[22] Prior to 2008, the Government had imposed alcohol duties on an ad valorem basis. The alcohol duty rates on liquor and wine were increased in 2001 and 2002 respectively to generate additional revenue. In 2008, in line with the policy to develop Hong Kong into a regional wine trading centre, the Government abolished its duties on wine and liquor with an alcoholic strength of not more than 30%. See Yoon et al. (2012).

[23] Since the abolition of the duty, Hong Kong has become one of the largest wine auction centres in the world, with a threefold increase in the total value of wine imports from HK$2,862 million in 2008 to HK$11,968 million in 2018. See Commerce and Economic Development Bureau (2021).

[24] Nevertheless, the Financial Secretary announced in the 2021-22 Budget his plans to raise the rate of Stamp Duty on stock transfers from 0.1% to 0.13%, as well as reviewing the case for introducing a progressive element to the rating system.

3. Global experiences in progressive taxes

3.1 The social purpose of taxation is to achieve a more even distribution of income and reduce the inequality of wealth. Through taxation, one can achieve horizontal equity where people with the same ability to pay are taxed the same, as well as vertical equity where people with higher income pay more taxes. Over the years, a number of developed economies have introduced taxes on **capital gains**, **dividends** and **luxury goods** with progressive elements to generate additional revenue and enhance tax equity.

Capital gains tax

3.2 A capital gain is an increase in the value of an asset or investment as a result of its appreciation in price.[25] CGT is a tax imposed on the gains realized or presumed to have been realized by the seller from the sale, transfer or disposal of a particular asset or investment. Capital gains are attributable to all types of capital assets, including but not limited to real estate, stocks and collectibles.

3.3 At present, the majority of OECD economies adopt one of following approaches to tax capital gains (**Table 1**):[26]

(a) **comprehensive income**: capital gains are taxed as part of ordinary income[27] and subject to the progressive income tax schedule. Nevertheless, preferential treatment is often provided to reduce the tax paid on certain types of capital gains. For instance, long-term capital gains in Australia and the United States ("US") are taxed at lower rates than short-term gains,[28] in an effort to deter speculation and minimize tax distortions on investment behaviour;

(b) **schedular tax**: capital gains are treated as conceptually distinct from ordinary income. A case in point is the UK where ordinary

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[25] See Corporate Finance Institute (2021).

[26] In Asia, OECD countries like Japan and South Korea have introduced CGT. In contrast, Singapore (a non-OECD country) does not levy taxes on capital gains.

[27] Ordinary income is understood broadly as personal income earned from labour.

[28] Both Australia and the US define short-term gains as gains on assets held for one year or less.

income and capital gains are subject to separate tax schedules at different progressive rates. Likewise, labour income and capital gains in the Netherlands are classified into separate "income boxes". A flat rate of 31% is charged on the presumed annual return of taxable capital assets;[29, 30] and

(c) **specific gains**: some OECD economies levy taxes on specific types of capital gains only. For instance, Germany levies CGT on gains from (a) properties held for less than 10 years; and (b) other private assets held for less than one year. In Switzerland and New Zealand, CGT is levied on properties but not on other asset types.[31] While this approach enables governments to target specific asset classes, it may also compromise horizontal equity as other capital gains are excluded from the tax net.

Table 1 – CGT approaches in selected OECD economies

Approach	Treatment of capital gains	Economies
Comprehensive income	• Capital gains are taxed alongside ordinary income, typically subject to the same marginal tax rates. • Preferential treatments may be afforded to specific types of capital gains, such as long-term gains.	• Australia, Canada, Denmark, Spain and the US.
Schedular tax	• Capital gains are treated as conceptually different from ordinary income, and they are subject to different tax schedules. • Different types of capital gains may be subject to different tax rates.	• Ireland, the Netherlands and the UK.
Specific types of capital gains	• Only specific types of gains (e.g. speculative gains) are subject to tax.	• Germany, New Zealand and Switzerland.

Sources: Freedman (2005) and Worldwide Tax Summaries (2021).

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29 The presumed annual rate of return for savings is 0.03% while that for investments is 5.69%. See Broadstreet (2020).

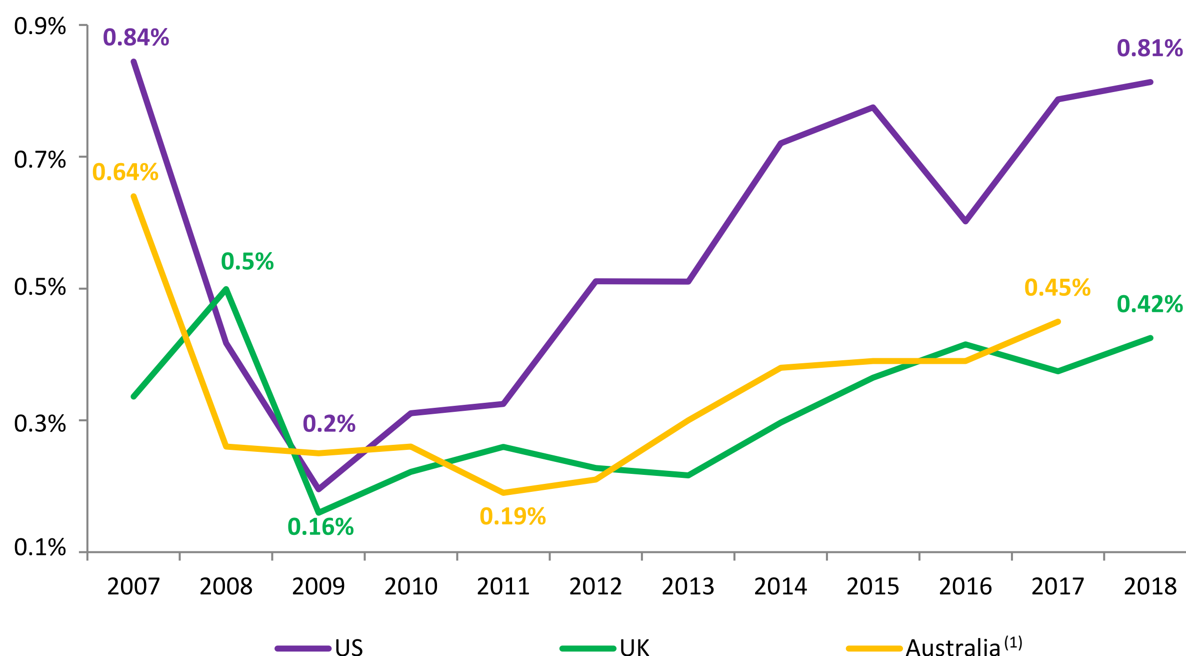
30 Since tax is levied on the presumed rather than actual returns, the Dutch system on capital gains is akin to a tax on wealth. See Brys (2006).

31 In New Zealand, the tax only applies to gains on properties bought for speculative purposes, defined as a transaction where the owner (a) has bought the property with the firm intention to sell it; (b) has a prior record of buying and selling; (c) is selling the property within the speculative period; or (d) is associated to a land dealer developer or builder. See Inland Revenue (2021).

Tax revenue of CGT

3.4 As regards revenue generation, CGT revenue tends to be more volatile compared to other taxes on ordinary income. As shown in **Figure 2**, during 2007-2018, CGT revenue as a percentage of GDP fluctuated within a wide range of 0.2%-0.84% in the US, 0.16%-0.5% in the UK, and 0.19%-0.64% in Australia. This owes to the fact that CGT is (a) sensitive to economic cycles; (b) dependent on a number of volatile factors such as stock and property market movements; and (c) deductible by capital losses which may offset the amount of CGT revenue[32].

Figure 2 – CGT revenue as percentage of GDP in the US, the UK and Australia, 2007-2018



Note: (1) There is no available information on Australia's CGT revenue in 2018.
Sources: Australian Taxation Office (2020), Office of Budget Responsibility (2021), and Organisation for Economic Co-operation and Development (2020).

3.5 Despite its volatile revenue generation, CGT is regarded as a useful tool in **protecting the income tax base**. With the inclusion of capital gains in the tax net, CGT removes the incentive for individuals to convert their income into

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32 This means that the amount of CGT revenue may be further reduced following periods of market downturn.

capital gains for tax avoidance or evasion purposes.[33] In Australia, the primary motivation for its CGT reforms in 1985 was to stem the growth in tax planning to mitigate tax liability. The same holds true for the UK which intended to prevent tax leakage by closing the gap between the tax rates for capital gains and ordinary income (see section 4 for further details).

CGT reliefs and concessions

3.6 Unlike taxes on ordinary income, CGT regimes often come with a greater number of tax reliefs and concessions. This is to mitigate the **economic distortions** caused by CGT, which include but are not limited to:

(a) **upward bias in the calculation of tax base**: CGT is often levied on the net profit (i.e. nominal gains) realized from the disposal of an asset. This imposes an undue burden on taxpayers who are taxed on both real and inflationary gains. In the past, some economies resolved this by indexing the base cost of the asset in line with inflation over the holding period.[34] Nowadays, tax discounts or rate reductions are provided instead;

(b) **lock-in effect**: CGT functions as a transactional tax which arises only when a taxpayer sells his or her investment in the market to realize the gain. Some taxpayers may thus choose to retain their current investments to avoid CGT, even if more profitable opportunities arise. This results in capital being locked into suboptimal investments. A number of economies mitigate this by providing tax reliefs for longer-term investments; and

(c) **disincentive on entrepreneurship and risk-taking**: entrepreneurs invest in their own business in hopes of generating financial return when it matures. Yet, CGT might reduce the rewards for such risk-taking, possibly resulting in lower levels of investment, economic growth and job creation. In response, some economies provide reliefs for entrepreneurs when they dispose of all or part of their businesses.

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33 The sharper the difference in treatment between capital gains and ordinary income, the greater is the opportunity for arbitrage between the two. See Freedman (2005), Institute for Fiscal Studies (2016) and Office of Tax Simplification (2020).

34 Indexation was more commonly adopted in the 1970s and 1980s, when inflation grew at a more prominent rate than today.

Dividend tax

3.7 Dividends are in-cash or in-kind[35] distributions paid out of the earnings or profits of corporate entities. While there is no dividend tax in Hong Kong[36], dividends are taxed in many other developed economies. In general, dividends can be taxed as (a) ordinary income under the comprehensive income approach; (b) separate tax under the schedular approach; or (c) withholding tax where the amount of tax payable is deducted at source[37]. The major approaches in taxing dividends by selected economies are highlighted in **Table 2**.

3.8 Apart from broadening the income tax base, dividend tax may be levied at progressive rates to enhance tax equity, as are the cases for Australia, the UK and the US. Nevertheless, the taxation of dividends gives rise to a number of concerns, including **double taxation** on corporate income. As a legal person, a corporation must pay tax on its profits. If the corporation is taxed on its profits and the dividends derived from those profits are also taxed when distributed to shareholders, the issue of double taxation arises. Modern dividend tax regimes often provide for relief measures to avoid or relieve double taxation. These include (a) imputing tax credits at the individual level for taxes paid at the corporate level;[38] or (b) providing other reliefs such as concessionary rates, tax allowances or partial exclusion to shareholders. Yet, administration of these reliefs usually involves complex rules and procedures.

3.9 In addition to the issue of double taxation, some doubt whether dividend tax could generate significant and stable tax revenue. In particular, revenue from dividend tax is easily affected by corporate dividend policies. Companies can choose to re-invest their profits in future projects or share repurchases instead of paying out dividends. This may be a concern for Hong Kong if it considers imposing taxes on dividends to broaden the tax base amid the spread of shareholding in the territory.

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[35] For example, a company may pay its dividends in the form of company's shares rather than in cash.

[36] Same as Hong Kong, Singapore does not generally levy taxes on dividends.

[37] Under a withholding tax regime, the corporation paying dividends withholds the amount of tax payable and pays out the remainder to the shareholders.

[38] Under the imputation system, shareholders receive a tax credit for the tax paid by companies on the portion of profits distributed as dividends.

Table 2 – Taxation of dividends in selected economies

System	Economies	Tax rate	Features	Revenue generated
Classical	Ireland	• 25% Dividend Withholding Tax ("DWT") on dividends paid by Irish resident companies.	• Revenue generated by DWT has enabled Ireland to **lower its corporate tax** rates.	• 0.7% of total tax receipts in 2019.[1]
Mixed classical	US	• Ordinary dividends are taxed at the same rates as ordinary income, with seven tax bands ranging between 10% and 37%.	• Qualified dividends[2] are taxed at 0%, 15% or 20%, the same rates for long-term capital gains. The **preferential rates** help reduce the economic distortions arising from taxing dividends and capital gains.	• Information not available.
	UK	• Dividends are subject to a separate schedule at basic (7.5%), higher (32.5%), or additional (38.1%) rates.	• An annual **tax-free dividend allowance** is provided, amounting to £2,000 (HK$19,920) in 2020-2021.	• 2.3% of total tax receipts in 2019-2020.
Imputation	Australia	• Dividends are taxed at the same rates as ordinary income, with four tax bands ranging between 19% and 45%.	• Domestic companies provide **tax credit** to shareholders when distributing dividends. The tax credit can be used to offset income tax liability, so as to avoid double taxation.	• 1.2% of total tax receipts in 2019-2020.

Notes: (1) The figure only includes DWT receipts but not other dividends charged under income tax.
(2) Qualified dividends are dividends on stocks of a US corporation or qualified foreign corporation that have been held for a specified period.

Sources: Budget 2019-20 (2019), HM Revenue & Customs (2021), and Revenue.ie (2020).

Tax on luxury goods

3.10 Generally, luxury goods tax is a tax on goods considered expensive, non-essential or consumed by only a niche.[39] Economies like Turkey, South Korea and Taiwan have introduced some forms of taxation on luxury goods to generate additional revenue (**Table 3**). It is typical for luxury goods to be taxed ad valorem, with tax rates that vary according to the price, volume or type of product.[40] Luxury goods taxes are seldom implemented in isolation, but are instead introduced on top of broader consumption-based taxes. This helps to ensure that (a) horizontal equity is preserved by subjecting a wider number of goods to tax; and (b) compliance costs are lowered since there is already a system in place for the taxation of goods and/or services.

3.11 Since luxury goods tax is generally levied on more valuable goods rather than necessities, it would not increase the burden of low-income earners and is in line with the "capacity to pay" principle. The amount of **revenue generated**, however, depends on how wide and steep the tax net is cast. For instance, the Special Consumption Tax ("SCT") in Turkey generated some 3% of total tax revenue in 2019. Yet, the scope of SCT is so broad[41] that it covers some common goods such as household appliances. This raises **equity concerns** as part of the tax burden is borne by lower-income earners. Furthermore, it has been argued that taxes on luxury goods might affect targeted businesses. For instance, the US abolished the luxury excise tax[42] in 1993 on the grounds that the tax "killed" the yacht industry and many other jobs.

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[39] There is no internationally or socially recognized definition of luxury goods.

[40] Ad valorem tax is strictly speaking a proportional rather than progressive tax. This means that it can be regressive if consumers of the commodity are not limited to those at the upper end of the income distribution. See Congressional Research Service (2013).

[41] On the other hand, a narrower tax net may not yield meaningful tax revenue unless the tax rates are very high.

[42] The US introduced an excise tax on luxury vehicles, furs, yachts, aircrafts and jewellery in 1990. See Congressional Research Service (2013).

Table 3 – Tax on luxury goods in selected economies

Economies	Scope of tax	Tax rate	Revenue generated
Turkey (Special Consumption Tax)	• Land, air and sea vehicles.	• Between 0.5% and 220% of sales price depending on value, type of vehicle, and engine size.	• 3% of total tax revenue in 2019.
	• Other luxury goods such as caviar, perfume and household appliances.	• Between 3% and 25% of sales price depending on type of product.	
South Korea (Individual Consumption Tax)	• Luxury watches, carpets and bags.	• 20% of sales price in excess of 2 million won (HK$13,200).	• Not available.
	• Luxury fur, furniture, jewellery and precious metal.	• 20% of sales price in excess of 5 million won (HK$33,000).	
	• Automobiles with engine displacement exceeding 1 000 cubic centimetres.	• 5% of sales price.	
Taiwan (Specifically Selected Goods and Services Tax)	• Passenger cars and air vehicles with sales price not less than NT$3 million (HK$783,000).	• 10% of sales price.	• 0.1% of total tax revenue in 2019.
	• Yachts with a length not less than 30.48 metres.		
	• Other items such as turtle shells, ivory, furs and furniture with sales price not less than NT$500,000 (HK$130,500).		

Sources: Gib.gov.tr (2021), Ministry of Economy and Finance (2019), and Laws & Regulations Database (2015).

4. Capital gains tax in selected places

4.1 The UK and Australia have introduced broad-based CGT regimes as early as in 1965 and 1985 respectively. The former adopts a schedular approach by taxing capital gains separately from ordinary income, whereas the latter taxes capital gains alongside ordinary income under the comprehensive

income approach. The UK and Australian CGT regimes have evolved over the years, reflecting the changing need to balance between protecting the tax base, promoting business investment, and maintaining simplicity of the tax regime.

Capital gains tax in the United Kingdom

4.2 Since its inception, the CGT regime in the UK has undergone successive reforms to reflect evolving policy goals and concerns. Although it was first levied as a proportional tax in 1965, the CGT rates were subsequently amended to align more closely or in line with the progressive income tax schedule[43]. In recent years, the government has phased out indexation and replaced it with other relief measures[44] to promote enterprise and incentivize long-term investment.

Salient features

4.3 At present, capital gains in the UK are subject to a progressive tax schedule which increases according to the amount of taxable income (**Table 1 of Appendix**).[45] CGT is chargeable on the net gains[46] made on a broad range of assets, with the exception of primary residence[47], private vehicles, personal possessions[48], and tax-free savings accounts. It is applicable to the worldwide gains made by residents domiciled in the UK[49].[50] Since 2019, non-UK residents

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[43] CGT was levied at a flat rate of 30% up until 1988, when the UK Chancellor for the first time aligned the CGT rates with those for income tax.

[44] For example, eligible taxpayers may be able to reduce the amount of CGT they have to pay though Business Asset Disposal Relief, or defer tax payment through Incorporation Relief and Gift Hold-Over Relief.

[45] The applicable CGT rate depends on the tax band into which the capital gains fall when added to the taxpayer's taxable income. This means that a basic rate taxpayer may be subject to higher CGT rates for the part of his or her net total income that exceeds the basic rate band.

[46] Losses made on chargeable assets – including those from previous tax years – may be used to offset the amount of taxable capital gains.

[47] A primary residence is eligible for the exemption provided that the owner has lived in the residence for all the time that he or she has owned it, and that the residence has not been used exclusively for business purposes.

[48] This is applicable to personal possessions (such as paintings, antiques and jewellery) worth £6,000 (HK$59,760) or more.

[49] For tax purposes, a person may be deemed domicile if he or she (a) was born in the UK, has the UK as domicile of origin, and was resident in the UK for 2017 to 2018 or later years; or (b) has been UK resident for at least 15 of the 20 years immediately before the relevant tax year.

[50] On the other hand, UK residents who are domiciled elsewhere are exempt from overseas capital gains that are not remitted to the UK.

are also subject to CGT for the disposal of any property or land within the UK. Given its status as a financial centre, the UK and foreign shares dominated the taxable gains in 2017-2018, accounting for 68% of the total. Residential land and buildings trailed at 14%.

4.4 In the UK, the design of CGT regime has evolved over the years to reflect different policy needs and concerns. The salient features of the current tax regime include:

(a) **CGT-specific tax-free allowance**: the UK regime incorporates a tax-free allowance which excludes gains at or below £12,300 (HK$122,508) from taxation.[51] According to the government, the allowance serves as an **administrative de minimis** by reducing the number of taxpayers who need to submit CGT information. It is estimated that the tax-free allowance exempts nearly 700 000 taxpayers from being brought into the CGT tax net;[52]

(b) **differential CGT rates**: since 2016, the UK government has imposed differential tax rates to reflect the government's policy stance towards different types of capital assets. In particular, higher tax rates are levied on (i) **residential property** to curb property speculation and incentivize investment in other assets; and (ii) **carried interest**[53] to reduce the incentive for private equity partners to convert their wages into capital gains; and

(c) **reliefs for business assets**: since its inception, the CGT regime has provided specific relief for the disposal of business assets. The current form of business relief – namely the Business Asset Disposal Relief ("BADR")[54] – was rolled out in 2008 with the aim of **stimulating business investment and risk-taking**. BADR provides a concessionary CGT rate of 10% on the disposal of qualifying business assets such as a sole trade, partnership

[51] The annual exempt amount increases each year in line with the rate of inflation.

[52] These taxpayers would yield negligible tax receipts due to their relatively low amount of gains.

[53] Carried interest is a form of performance-linked reward. It typically entitles the managers/partners of private equity funds to a certain percentage of the fund's overall profits after return of capital to investors in the fund. This is in addition to any salary and bonus to which they may be entitled. A larger gap in tax rate between wage income and carried interest would provide a greater incentive for the managers/partners to invest more of their remuneration as carried interest.

[54] Prior to March 2020, BADR was known as the Entrepreneurs' Relief.

interests or shares in a company. In order to claim BADR, the business owner/investor is required to hold the qualifying asset for at least two years.[55]

In 2018-2019, BADR resulted in £2.4 billion (HK$25.1 billion) tax revenue forgone for the UK government. Around 74% of BADR gains were accrued to just 2.2% of taxpayers who were earning capital income at or above £1 million (HK$9.96 million). This has given rise to concerns that BADR disproportionately benefit high-income taxpayers. In response, the UK government has since March 2020 **reduced the lifetime limit of BADR** to just £1 million (HK$10 million) of taxable gains, as opposed to the previous limit of £10 million (HK$99.6 million).

4.5 In July 2020, the UK government commissioned the Office of Tax Simplification ("OTS")[56] to identify ways to streamline the current CGT regime. The ensuing review has raised some concerns pertaining to the design of CGT as well as efficacy of business reliefs. For instance, the review suggested that there is a case for further convergence of tax rates between capital gains and ordinary income based on the equity principle[57]. It also recommended restricting the scope of business reliefs, as BADR has become too costly with limited success in promoting risk-taking[58]. However, the UK government has yet to respond to OTS's recommendations.

Effect of CGT

4.6 As a progressive tax, CGT was borne by just 256 000 taxpayers or 0.5% of the adult UK population in 2018-2019. By comparison, income tax was borne by over 60% of the adult UK population in the same year. Despite the much smaller tax-paying population, CGT contributed £9.8 billion (HK$ 97.9 billion) to the public coffers in 2018-2019, equivalent to 5.1% of

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[55] In general, a business investor must also be an office holder and/or own at least 5% of shares and voting rights of the company to claim BADR.

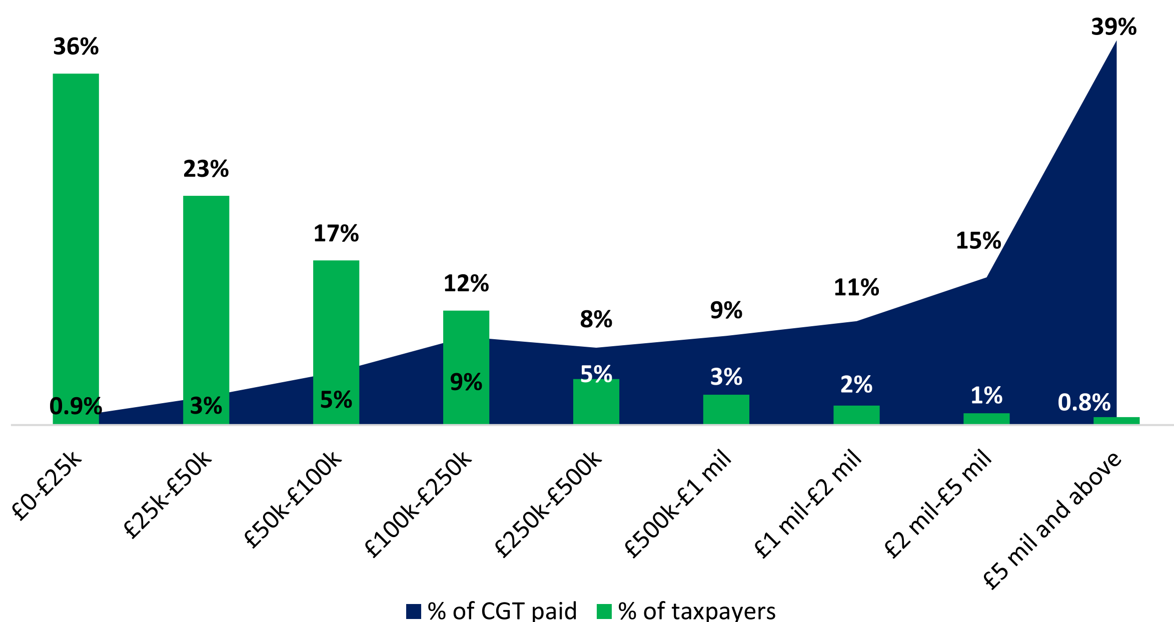
[56] OTS is the independent adviser to the government on simplifying the UK tax system.

[57] If CGT rates were more closely aligned with income tax rates, OTS estimates that it could theoretically raise an additional £14 billion (HK$146 billion) per year for the Exchequer.

[58] According to Office of Tax Simplification (2020), risk-taking would be better encouraged by upfront cash relief than by an eventual reduction in a tax liability on disposal. This is because, at the point of investment, investors are interested in the overall return and not the tax position of the venture.

income tax receipts or 1.2% of total public receipts. This accords with the UK government's stated goal of **protecting/broadening the income tax base** without affecting the majority of taxpayers.[59] Furthermore, 54% of CGT revenue was accrued to the top 1.8% of CGT taxpayers in 2018-2019 (**Figure 3**), suggesting that those who are more capable to pay does in fact bear a heavier tax burden.

Figure 3 – Percentage shares of taxpayers and CGT revenue by amount of capital gains, 2018-2019



Source: HM Revenue and Customs (2020).

4.7 Ever since the UK introduced CGT in 1965, there have been concerns that the tax might act as a barrier to economic growth by deterring investments in the economy. Against this, there are studies suggesting that the taxation of capital gains does not necessarily correlate with muted growth or investment.[60] As demonstrated in **Figure 4**,[61] notwithstanding the record-high top marginal

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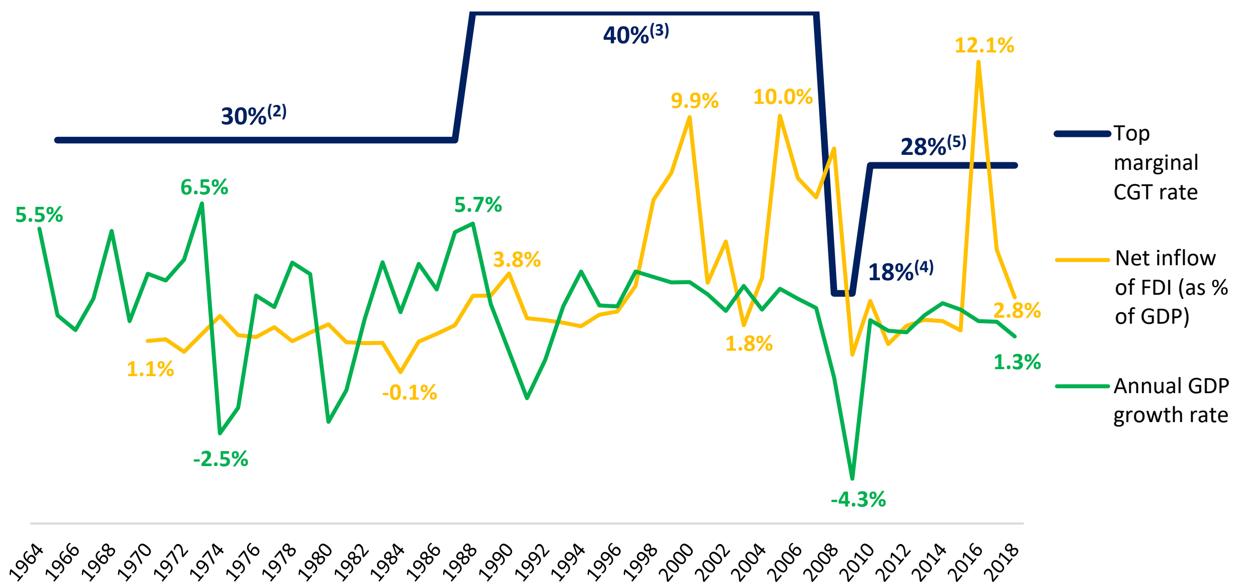
[59] See, for instance, House of Commons Library (2010) and Office of Tax Simplification (2020).

[60] According to the literature review by Gale & Samwick (2014), there are researches showing that changes in tax rate (including the CGT rate) impose little to no effect on economic growth in developed countries.

[61] In 2020, the Urban Institute & Brookings Institution studied the relationship between the top marginal CGT rate and GDP growth in the US from 1954 to 2019. Among others, the Institution found that the tax rate on capital gains does not appear to be a major factor in influencing economic growth. Figure 4 follows the same approach to identify any impact of marginal CGT rate on GDP growth in the UK. See Urban Institute & Brookings Institution (2020).

CGT rate of 40% from 1988 to 2008, the UK economy still saw strong business investment as measured by the net inflow of foreign direct investment ("FDI"). Furthermore, despite a number of changes to the CGT rate since 1965, it has had limited impact on the UK's annual GDP growth rate.

Figure 4 – Top marginal CGT rates, GDP growth and net FDI inflows, 1964-2018[(1)]



Notes: (1) There is no available data on the net inflow of FDI prior to 1970.
(2) In 1965, CGT was first introduced with a single flat rate of 30%.
(3) In 1988, CGT rates were aligned with the income tax rates with a top marginal tax rate of 40%.
(4) In 2008, CGT rates were reduced to a single flat rate of 18%.
(5) In 2010, the progressive CGT rate schedule with a top marginal tax rate of 28% was introduced. Since 2016, the top marginal tax rate only applied to gains on residential property and carried interest.

Sources: HM Revenue and Customs (2020) and The World Bank (2021).

Capital gains tax in Australia

4.8 In Australia, the broad-based CGT was introduced in 1985 among a suite of measures to improve tax efficiency, equity and revenue security. The policy objective at that time was to address gaps in the income tax base[62], which had led to increased tax avoidance and evasion activities.[63] Since its inception,

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[62] According to Reinhardt et al. (2006), the lack of CGT had distorted investment towards assets providing returns in the form of capital gains, rather than income streams, and provided an incentive to convert income into capital gains.

[63] In 1985, the Labor government recommended broadening the tax base through the adoption of a broad-based consumption tax, as well as the introduction of CGT and comprehensive taxation of fringe benefits.

capital gains have been taxed as part of the income tax net. There was originally a system of indexation to preclude inflationary gains, as well as averaging[64] to reduce the fluctuation of taxable gains. Following a review of the CGT regime in 1999,[65] the above provisions had been phased out as they were considered too complex to administer. Instead, the government has introduced a suite of tax reliefs and concessions to encourage domestic investment and enhance the international competitiveness of its tax regime (see paragraphs 4.12-4.13 below).

Salient features

4.9 Under the comprehensive income approach, net capital gains in Australia are reported as part of the income tax return. In Australia, as in the UK, CGT applies to the worldwide gains made by Australian residents. It is also applicable to foreign residents who make capital gains on specified assets, such as real properties and assets that have been used to carry on a business in Australia.[66]

4.10 The income tax schedule in Australia is progressive with relatively high marginal tax rates at medium and high levels of income (**Table 2 of Appendix**). A general tax-free threshold of A$18,200 (HK$97,552) applies to all types of income. The broad-based CGT applies to most types of assets, with the exception of main residence[67], personal vehicles, and personal items and collectables[68]. In order to prevent the arbitrary claiming of capital losses, depreciating assets used solely for taxable purposes are also excluded.

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64 The provisions enabled capital gains to be averaged over a maximum of five years to allow for fluctuations in the amount of tax levied.

65 The review sought to optimize Australia's economic growth without adversely affecting the tax revenue for the public coffers. See Freebairn (2005).

66 See Australian Taxation Office (2020).

67 A main residence may be entitled to a full or partial exemption depending on the individual circumstance. In general, a dwelling may qualify for the full exemption if (a) it has been the home for the owner or his/her dependants for the whole period of ownership; (b) it has not been used to produce assessable income; and (c) it is on land of two hectares or less.

68 Personal use items acquired for less than A$10,000 (HK$53,600), as well as collectables acquired for A$500 (HK$2,680) or less, are not subject to CGT.

4.11 The CGT regime in Australia has evolved over the years to incorporate the following features:

(a) **discount on long-term gains**: compared with its OECD counterparts, Australia has a relatively higher marginal tax rate for capital gains. It has since 1999 put in place a 50% CGT discount for assets held for more than 12 months[69], which amounts to a concessionary rate for long-term capital gains. The favourable tax treatment aims to facilitate **efficient investment decisions**[70] and help lower Australia's CGT rate relative to its international counterparts.[71] Australia has seen some growth in its net FDI inflow following the introduction of this measure;[72] and

(b) **transitional measure**: upon the introduction of CGT in 1985, the Australian government adopted a "grandfather clause" so that assets acquired before the implementation of CGT could retain their tax-free status.[73] This was seen at the time as a facilitation measure in **transitioning towards a CGT regime**, and the "grandfather clause" has since become a distinct feature of Australia's tax regime.

4.12 In addition to the above, a suite of CGT concessions is provided to facilitate small business owners' **access to funds for expansion or retirement**.[74] The concession scheme enables eligible owners to reduce or even eliminate their CGT burden under one or more of the following favourable tax treatments:

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[69] The 50% CGT discount is applied on the amount of taxable gains, and only local residents are entitled to the relief.

[70] Among others, the 50% discount reduces the tax bias towards retaining assets, i.e. the lock-in effect. See Reinhardt et al. (2006).

[71] Australia had the highest top marginal CGT rate in 2020 among 28 selected OECD economies. With the 50% CGT discount taken into consideration, Australia's top marginal CGT rate ranked 17th out of the 28 OECD economies in the same year. See Tax Foundation (2020).

[72] Indicative of this, Australia's net FDI inflow increased from 0.6% of GDP in 1999 to 3.7% of GDP in 2002. See The World Bank (2021).

[73] The clause applies to most assets acquired before 20 September 1985.

[74] See Sadiq (2015).

(a) **15-year exemption** is a retirement relief which exempts all capital gains on the sales of an active asset[75]. It applies to retiring owners who are aged 55 or over and have continuously owned the asset for 15 years or more;

(b) **50% active asset reduction** is a general business relief which reduces the capital gain on an active asset by 50%.[76] The relief may be claimed by all eligible small business owners; and

(c) **small business rollover** allows business owners to defer all or part of a capital gain when they dispose of some active asset and acquire replacement asset within a two-year period. The rollover relief ensures owners can gain adequate access to funds.

4.13 Unlike the UK, Australia provides business concessions with more targeted exemption, reduction and/or rollover reliefs. In order to qualify for the concessions, small businesses are required to meet relatively complex **qualifying tests** pertaining to their annual turnover, net value and asset type.[77] The concession measures – set out in nearly 50 pages of tax legislation – have been cited as a source of complexity which may lead to increased compliance costs and distortions in business decision-making.[78]

Effect of CGT

4.14 In 2017-2018, the Australian government received A$8.3 billion (HK$48.6 billion) in CGT, accounting for 3.9% of individual income tax revenue or 1.9% of total tax revenue.[79] In recent years, the taxation of capital gains has

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[75] A CGT asset is an active asset if (a) its owner uses it or holds it ready for use in the course of carrying on a business (whether alone or in partnership); or (b) it is an intangible asset inherently connected with a business carried on (whether alone or in partnership).

[76] The discount is applied on top of the 50% CGT discount on assets held for 12 months or more.

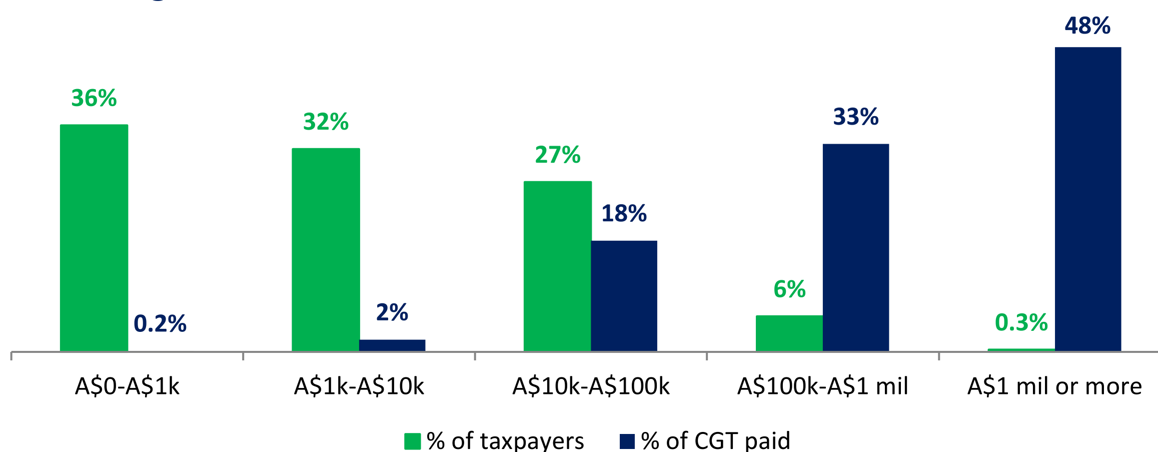
[77] Among others, the small business should (a) record less than A$2 million (HK$10.7 million) in aggregated turnover; (b) have less than or equal to A$6 million (HK$32.2 million) in net asset value; and (c) satisfy the active asset test. The active asset test requires the CGT asset to be an active asset for (a) at least half of the period of ownership if held for 15 years or less; or (b) at least 7.5 years if held for more than 15 years. Cash, financial instruments and rental properties are generally not considered as active assets.

[78] In 2019, a government-appointed review recommended simplifying the qualifying tests, as well as imposing a cap on the amount of claimable concessions. See The Board of Taxation (2019).

[79] See Australian Taxation Office (2020).

affected some 5% of income taxpayers in Australia. Since Australia does not provide any CGT-specific tax-exempt allowance, its number of CGT taxpayers is larger than that in the UK[80]. Nevertheless, the CGT regime remains by and large **progressive**, where most of the tax on capital gains (i.e. 81%) was accrued to the top 6.3% of CGT taxpayers (**Figure 5**).

Figure 5 – Percentage shares of taxpayers and CGT revenue by size of capital gain, 2017-2018



Source: Australian Taxation Office (2020).

4.15 In Australia, tax reliefs help mitigate CGT's economic distortions, but they might also undermine the simplicity and equity of the tax regime. For example, the 50% CGT discount has come under scrutiny in recent years. The measure was first introduced on the grounds that it would enhance Australia's tax competitiveness while having a neutral effect on tax revenue. Yet, the CGT discount had resulted in increased amounts of revenue foregone for the Australian government, rising from A$1.4 billion (HK$6.3 billion) in 2000-2001 to A$10.3 billion (HK$61.4 billion) in 2017-2018.[81] Furthermore, as seen in **Figure 6**, the distribution of the CGT discount was skewed towards high-income taxpayers, where some 73.2% of benefits were accrued to the top 10% of households in 2014-2015.[82] This raises **concerns over horizontal equity** as other types of income, such as wage and dividends, are not eligible for the same discounts.

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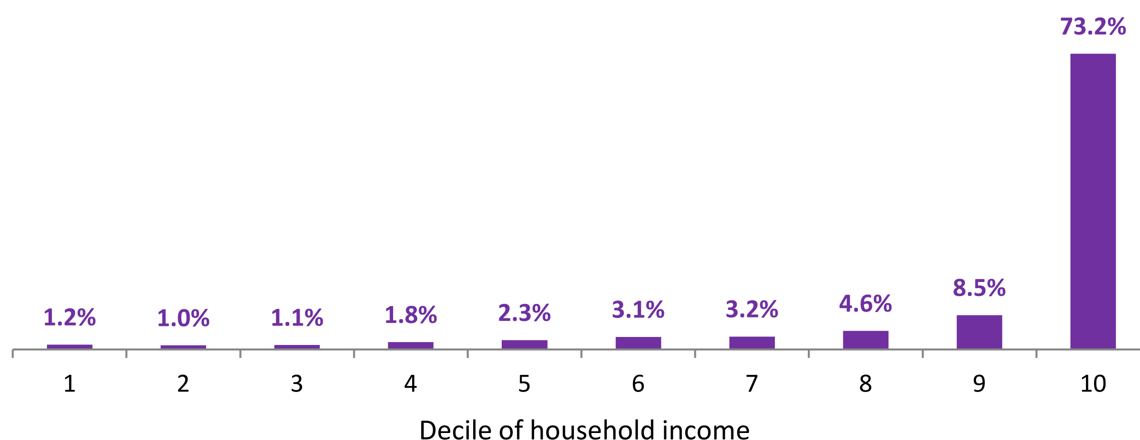
[80] In contrast, only around 0.8% of income taxpayers are subject to CGT in the UK.

[81] In 2017-2018, the CGT discount was the fifth largest tax expenditure for the Australian government. See Commonwealth of Australia (2018).

[82] The figures are computed from official figures by The Australia Institute (2015).

Figure 6 – Distribution of CGT discount benefits by household income, 2014-2015[(1)]



Note: (1) The figures for 2014-2015 are the latest available figures in the public domain.
Source: The Australia Institute (2015).

4.16 Amid the equity concerns, some have called for reducing the CGT discount rate and applying it to other related types of income[83]. Alternatively, others suggest replacing the discount with a CGT-specific tax-exempt allowance similar to the case of the UK.[84] Yet, the aforementioned proposals are controversial as they might amount to a tax raise for some taxpayers, and the Australian government has yet to put forth any concrete proposals.

5. Concluding remarks

5.1 In Hong Kong, concerns over persistent fiscal deficit until 2024-2025 have rekindled discussions over the need to reform the existing tax regime. Introduction of progressive taxes on capital gains, dividends and luxury goods has been discussed as a possible measure to broaden the tax base and replenish the public coffers.

5.2 Many developed economies have implemented CGT regimes, usually under the schedular tax or comprehensive income approach. The UK and Australia are early adopters which introduced broad-based CGT in 1965 and

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[83] For instance, the Henry Review in 2010 recommended applying a uniform 40% discount on income from bank deposits, bonds, rental properties, as well as capital gains. See Commonwealth of Australia (2010).

[84] This move would also enhance the vertical equity of the tax regime, as taxpayers who accrue lower capital gains could enjoy a larger discount effect. See Freudenberg et al. (2019).

1985 respectively. The UK taxes capital gains in a progressive manner under a dedicated tax schedule, with a CGT-specific tax-free allowance to lower administrative costs and compensate for inflation. In contrast, Australia taxes capital gains alongside ordinary income under the comprehensive income approach. A 50% discount on taxable long-term gains is provided to reduce CGT's economic distortions.

5.3 Both the UK and Australia have made available concessions for small businesses in order to promote entrepreneurship. Australia provides a suite of exemption, reduction and rollover reliefs to ensure that qualifying small businesses can gain access to funds for expansion. In contrast, the UK provides a single relief on the disposal of business assets to reduce the amount of CGT payable and thereby incentivize investment and risk-taking. Yet, these relief measures have also resulted in increasing amounts of revenue foregone, prompting both governments to explore restricting the scope and/or imposing lifetime limits on them.

5.4 Based on the UK and Australian experiences, the tax revenue generated by CGT is relatively volatile and vulnerable to economic cycles. That said, taxation of capital gains provides an avenue to protect and broaden the income tax base without affecting the bulk of taxpayers. In particular, CGT regimes are largely progressive with those who are more capable bearing a substantially heavier tax burden. Nevertheless, the launch of CGT may bring about economic distortions such as upward bias in calculation of tax base, suboptimal investments resulting from the lock-in effect, and disincentive on entrepreneurship and risk-taking. While tax reliefs help mitigate the economic distortions, they might affect tax equity by favouring some capital gains over others, as well as complicate the tax regime by increasing the costs of compliance.

5.5 Dividends are subject to tax in the majority of developed economies. Similar to capital gains, dividends may be taxed in a progressive manner as part of ordinary income or under a separate tax schedule. The issue of double taxation may be mitigated by imputation or other reliefs such as preferential rates and tax-free allowances. Notwithstanding this, dividend tax may also give rise to economic distortions. For instance, in economies where the tax rate on dividends is higher than that on capital gains, companies might choose to re-invest their profits in future projects or share repurchases instead of paying out dividends even if they have made a profit.

5.6 At present, only a limited number of economies have imposed taxes on luxury goods, owing to concerns over their adverse impact on the related business sectors. In places such as South Korea and Turkey, ad valorem taxes on luxury goods are implemented alongside broader consumption-based taxes to minimize complexity and preserve tax equity. Ultimately, the amount of revenue generated by taxing luxury goods hinges on how wide and steep the tax net is cast.

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10 May 2021
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Appendix

Table 1 – CGT tax schedule in the UK for 2020-2021

Level of taxable income	Standard income tax rate	CGT allowance	Standard CGT rate	CGT rate for residential properties[1]	Gains qualifying for Business Asset Disposal Relief
At or below £50,000 (HK$498,000)	Basic rate (20%)	£12,300 (HK$122,508)	10%	18%	10%[2]
£50,001-£150,000 (HK$498,010-HK$1,494,000)	Higher rate (40%)		20%	28%	
Over £150,000 (HK$1,494,00)	Additional rate (45%)				

Notes: (1) Carried interest (i.e. share of profits from private equity funds) is also subject to a higher tax rate.
(2) This is subject to a lifetime limit of £1 million (HK$10 million) on qualifying capital gains.
Source: Office of Tax Simplification (2020).

Table 2 – Income tax schedule in Australia for 2020-2021[1]

Level of taxable income	Marginal tax rate
A$0-A$18,200 (HK$0-HK$97,552)	0%
A$18,201-A$45,000 (HK$97,557-HK$241,200)	19%
A$45,001-A$120,000 (HK$241,205-HK$643,200)	32.5%
A$120,001-A$180,000 (HK$643,205-HK$964,800)	37%
A$180,001 or above (HK$964,805 or above)	45%

Note: (1) Net capital gains are reported as part of the income tax return in Australia.
Source: Australian Taxation Office (2020).

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