Inflation and CGT: Investors Beware

Everyone knows that inflation is a government-orchestrated swindle that takes purchasing power from savers and delivers it to the government and its preferred constituency, borrowers. Well, everyone *should* know this.

But under the current capital gains tax (CGT) rules, it's a swindle of an even higher magnitude. Not only is inflation going to erode your wealth, but you're going to collect a nice big tax bill for the pleasure.

Before 21 September 1999, capital gains were generally taxed at your top marginal tax rate (plus the Medicare levy). The Howard government introduced a 50% capital gain tax (CGT) discount for assets held longer than one year. So, if under the old system you were due to pay a 40% tax on capital gains, under the new system you'd only pay 20%. So far, so good.

But the bit that wasn't trumpeted in the press release was that they also scrapped indexing. And it's a biggie. Indexing adjusts for the debilitating effects of inflation on an investment. So under the old system, you got taxed on the real (inflation-adjusted) capital gain, whereas today you get taxed on the nominal gain.

I'm quite concerned about the likelihood of inflation as an after-effect of current initiatives aimed at the global financial crisis. I'm searching for good inflation hedges.

Assume I can find a conservative investment that pays little income but has a value that grows in line with the consumer price index (CPI), an official measure of inflation. If you trust the way the CPI is calculated – and I don't – then it means one dollar invested in this structure would grow into an amount that buys what $1 buys today, whether we took our money out in two years or 20.

Let's say that, happy to have my money protected against inflation, I placed $100,000 in this conservative investment for 20 years. And let's say that, over the following 20 years, inflation averaged 5%. Come 2029, my money has compounded at 5% and the investment is worth $265,330.

If the old tax system was still in operation, the Australian Tax Office would recognise that $100,000 doesn't buy what it used to. I'd be able to 'index' that money, and convert it into 2029 dollars. Following the indexing schedule, they'd say that $1 invested in 2009 equates to $2.6533 because of inflation (1 times 1.05^20). So I'd multiply my original nominal cost base of $100,000 to arrive at a real cost base of $265,330. The ATO would agree that I haven't made any real capital gain, and I wouldn't owe any capital gains tax on the investment. It makes sense considering the structure of the investment.

Under the current tax system, though, I'd have to declare a capital gain of $165,330 ($265,330 - $100,000). I then get the privilege of applying the capital gains tax 'discount', halving the gain to $82,665 because I've held the investment longer than one year. I would then pay tax on this gain at, say, 40% - so I'd owe the ATO $33,066. See the problem? My conservative

investment, designed to keep up with inflation, doesn’t achieve its aim. On a post tax basis, my return falls to 4.3%, and in 2029 I cannot buy as much as I could have if I’d spent the money in 2009. Thanks for the tax cut!

If I can do substantially better than inflation, the current system is obviously better than the old. Assume I make an identical (but riskier) investment that successfully grows at twice inflation (a 10% nominal return). It would be worth $672,750 come 2029. Under the old system, I would have paid capital gains tax, at 40%, of $162,968 and achieved a post-tax rate of 8.5% per annum. Under the current system, paying an effective 20% tax rate but with no indexing, I’d pay $114,550 in capital gains tax, for an after tax return of 9.0%.

But the higher inflation gets, the harder it is to beat. Simply keeping up with inflation would be a commendable investing performance if prices start to skyrocket. Even those that don't manage this feat and suffer a decline in their real spending power, though, will see their wealth further eroded thanks to a hefty bill from the tax office.